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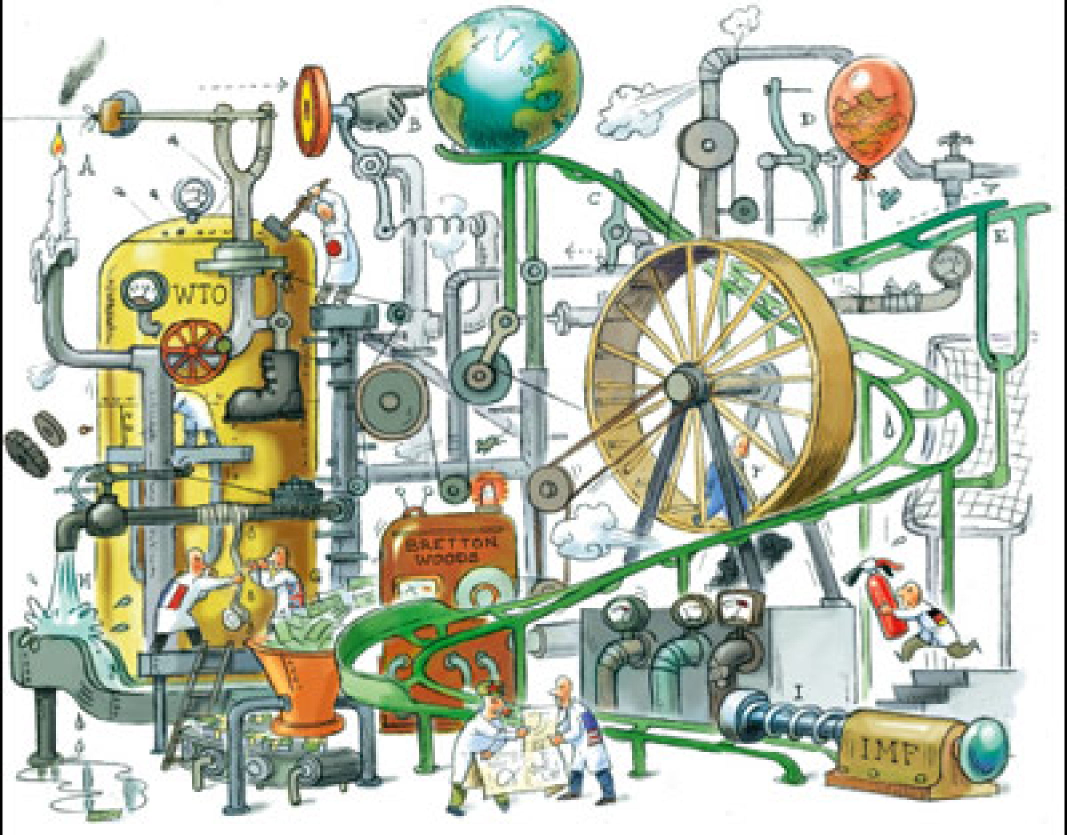

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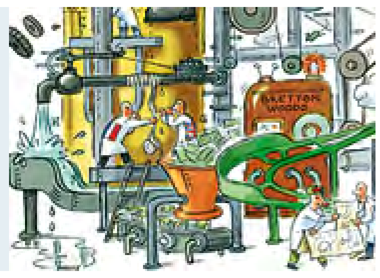
Redesigning global finance

Government leaders cannot rewrite the rules this weekend. But they can still do some useful things: leader



The world this week

Politics this week
Business this week
KAL's cartoon

Leaders

The world economy
Redesigning global finance

China's fiscal stimulus
Dr Keynes's Chinese patient

Protecting the vulnerable
What Congo means for Obama

Carmakers
Saving Detroit

A modest proposal
O give me a home...

Letters

On our endorsement of Barack Obama

Briefing

The global economic summit
After the fall

United States

The presidency
Change.gov

Congress
Waiting for reinforcements

Government finances
Local zeroes

Florida
Snowbirds, meet the repo men

Chicago
The spotlight beckons

School reform
A worthy experiment

Lexington
Ship of fools

The Americas

Nicaragua
How to steal an election

The Latinobarómetro poll
Democracy and the downturn

Canada's economy
Breaking the deficit taboo

Asia

Australia and the credit crunch
Digging for victory

New Zealand's election
Key change for Kiwis

Indonesia after the Bali bombers
Secular trends

Australia and the death penalty
All right then, just this once

Bhutan's newly crowned king
Crowning glory

Kazakhstan's "New Silk Road"
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Nov 8th 2008
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Failure to deliver

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Watching the watchers

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Centres of attention

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Place your bets

Aviation in China
Chocks away

Face value
Portal of doom

Briefing

China's economy
Reflating the dragon

Finance and economics

Debt and deflation
Depressing times

The Federal Reserve
Turning Japanese

AIG
Cheque mate

Buttonwood
An appetising spread

Japan's economy
A tunnel, no light

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Europe

France's president
Is Sarkozy a closet socialist?

Germany's economy
A little stimulus

Higher education in Italy
A case for change

Eastern Europe and America
Looking west, hopefully

Tuna in the Mediterranean
Gone fishing

Moldova and Transdniestria
Another forgotten conflict

Charlemagne
No room in the ark

Britain

Politics and the recession
Bigger, wider, deeper

Interest-rates outlook
Plumbing new depths

Renewable energy
The green pound

Child-killing
Most foul

Scottish politics
The union forever?

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Ancient bling

Obituary

Miriam Makeba

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Politics this week

Nov 13th 2008
From The Economist print edition

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Barack Obama paid his first visit to the White House since winning America's election to discuss the transition of power with George Bush. With Congress returning to pass another stimulus package, Mr Obama pressed Mr Bush on an immediate bail-out of Detroit's troubled carmakers. Meanwhile, leaders from the G20 countries headed to Washington for an economic summit, dubbed **Bretton Woods 2**, on November 15th that will discuss reform of the world's financial system. See article

The Democrats' tally of seats in the **Senate** rose to 57 after returns from Oregon showed that the incumbent, a moderate Republican, had been defeated. In other Senate races, the 206-vote margin obtained by Norm Coleman in Minnesota will trigger an automatic recount; Georgia is to hold a run-off election in December; and Alaska's Senate race was level as the absentee-ballot count got under way. Ted Stevens is defending his seat there. See article

Thousands of protesters held rallies across California in defence of **gay marriage**, a week after voters narrowly approved a ballot initiative that nullifies a court decision legalising gay nuptials. Same-sex marriage supporters received a boost when a judge in Connecticut cleared the way for the legalisation of gay marriage in the state.

Nebraska was set to award one of its five electoral-college votes to Mr Obama, who won the majority of votes in Omaha. It is the first time in the modern era that a state has split its electoral-college vote (Nebraska and Maine are the only states with a proportional electoral-college system).

A Congolese conflagration

Laurent Nkunda, the Congolese rebel leader who is besieging the eastern city of Goma, said his forces were ready to fight African peacekeeping troops if they attacked. Leaders from southern Africa said they were ready to send soldiers to **Congo** "if and when necessary", raising fears of a regional war. The UN Security Council deferred a request for 3,000 extra troops from the organisation's head of peacekeeping. See article

Acting on a French warrant, German police detained Rose Kabuye, a senior aide to **Rwanda's** president, Paul Kagame, on charges of involvement in the shooting down of a plane that killed the former president Juvenal Habyarimana in 1994. That attack sparked the genocide of ethnic Tutsis and moderate Hutus by Hutu extremists. Rwanda expelled the German ambassador. See article

Sudan's President Omar al-Bashir announced a ceasefire by government troops in the Darfur region. It was the latest of several such declarations since 2004, none of which has stopped the fighting between government troops, their Arab militias and armed Darfuri rebel groups.

Nir Barkat, a pro-secular entrepreneur, was elected as mayor of **Jerusalem**. He has promised to maintain the city's unity under Israeli control. See article

Syria dismissed a leaked report that nuclear inspectors had found traces of uranium at an alleged nuclear facility that was bombed by Israel last year. Syria said the uranium could have come from munitions dropped by Israeli jets. Separately, Britain's foreign secretary, David Miliband, praised Syria for opening diplomatic relations with Lebanon and preventing foreign fighters infiltrating Iraq.

State haul

EPA

Chen Shui-bian, president of **Taiwan** until last May, was arrested. He faces corruption allegations, which he denies, and says he is being persecuted to appease China.

A court in **Myanmar** sentenced 30 opposition activists to up to 65 years in jail. They include veterans of the 1988 students' movement and others who came to prominence in the thwarted monk-led protests of September 2007.

A senior Chinese official reported that no progress had been made in the latest round of talks with representatives of the Dalai Lama. The official accused **Tibet's** exiled spiritual leader of continuing to seek "disguised independence" for his homeland.

Mohamed Nasheed was sworn in as the new president of the **Maldives**. He said he was considering setting aside money to buy a new homeland for his people, whose 1,200 islands are threatened by rising sea levels. See article

In **Indonesia**, three perpetrators of the bombing in Bali in 2002, in which 202 people were killed, were executed. Islamist extremists threatened reprisals. See article

New Zealand has a new prime minister, John Key of the National Party, which defeated Helen Clark's Labour in a general election. See article

Haitian horror

More than 90 people were killed when a school building collapsed in **Haiti**. Authorities blamed poor construction; the school's owner was arrested.

Nicaragua's opposition parties accused Daniel Ortega, the leftist president, of rigging municipal elections to deprive the opposition leader, Eduardo Montealegre, of victory in the contest for mayor of Managua, the capital. See article

Costa Rica's legislature voted to implement the Central America Free Trade Agreement, ratified by other countries in the region and by the United States. Costa Rican voters narrowly approved the pact in a referendum in October 2007.

Hurricane Paloma destroyed thousands of homes in **Cuba**.

Ontario's premier pressed Stephen Harper, **Canada's** Conservative prime minister, to help the province's car industry, to match any bail-out of carmakers in the United States. See article

Not quite friends again

European Union foreign ministers agreed to restart talks on a new partnership agreement with **Russia**, even though the Russians have not complied with EU demands to pull all their troops out of Georgia after the August war. Only the Lithuanians refused to back the EU's about-turn. See article

Twenty **Russians** were killed when gas-filled fire extinguishers went off on board the *Nerpa*, a nuclear submarine. India said it was due to lease the submarine next year.

AP

Serbian police searched a factory where Ratko Mladic, the Bosnian Serb wartime commander, was thought to be hiding. The renewed hunt for General Mladic confirms that **Serbia** is tilting in a more pro-European direction.

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Business this week

Nov 13th 2008
From The Economist print edition

In a surprise turnaround, Hank Paulson, America's treasury secretary, said that the remaining funds in the government's $700 billion **Troubled Asset Relief Programme** would be best used to provide capital infusions to distressed companies and tackle consumer debt, rather than buy illiquid mortgage-related assets. (The Treasury has already spent $250 billion on bank recapitalisations.) Congress approved the package a little over a month ago on the basis that the illiquid assets would be bought. Already gloomy investors interpreted the policy negatively and stockmarkets fell sharply. See article

In an attempt to help struggling **homeowners** in America, the agency that oversees Fannie Mae and Freddie Mac outlined a plan to avoid "preventable" foreclosures. Households that have missed three or more mortgage payments may receive assistance through refinanced mortgages with lower interest rates and longer payment periods of up to 40 years. Home foreclosures have increased by almost 150% over the past two years.

The terms of **AIG's** bail-out were renegotiated, resulting in an expanded package worth $153 billion. In September the government took a stake of almost 80% in the insurer and provided it with $85 billion amid the fallout from the collapse of Lehman Brothers. An additional $38 billion was made available in October, but the company is still in trouble; it reported a $24.5 billion net loss for the third quarter and booked more write-downs. See article

AIG's latest rescue deal brought demands from Democrats for a speedy bail-out of **Detroit's carmakers**. General Motors' share price plummeted to a 65-year low after it made another big loss, though analysts were more concerned at the rate at which GM and Ford were tapping their cash reserves to see them through an adverse market—$6.9 billion in the quarter for GM and $7.7 billion for Ford. See article

You've been approved

The Federal Reserve gave **American Express** the go-ahead to turn itself into a bank. The decision gives America's only remaining big independent credit-card company greater access to government funding.

UBS confirmed that American prosecutors have charged one of its most senior executives with conspiring to help wealthy clients hide assets from the Internal Revenue Service. Raoul Weil is chairman of the Swiss bank's global wealth-management business and a member of the executive board. He stepped down from his duties to fight the case. The allegations form part of a long-running investigation by American authorities into the secretive relationships between Swiss banks and their rich customers.

HBOS rebuffed an attempt by two former Scottish banking chief executives to scupper its rescue merger with **Lloyds TSB**. The rescue is backed by the British government, which waived competition rules to see the deal through. See article

Slow, slow, quick, quick, grow

China unveiled proposals worth 4 trillion yuan (nearly $600 billion) to boost its economy. The measures, some of which have already been made public, boost spending in infrastructure, construction, agriculture and welfare. See article

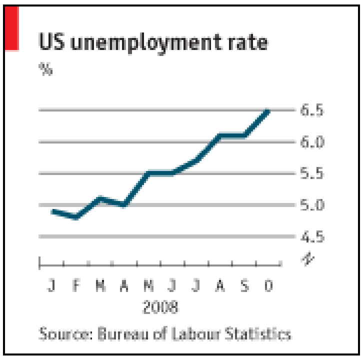
The **World Bank** said it would make an additional $100 billion available to developing countries over the next few years. Robert Zoellick, the bank's president, said that "virtually no country has escaped" the financial and economic crisis, but that poorer countries were particularly vulnerable to a slowdown in the global economy and decline in world trade.

NRG Energy rejected **Exelon's** $6.2 billion unsolicited takeover offer partly because of Exelon's "obvious difficulties on both the debt financing and credit-rating front".

The **price of oil** closed below $60 a barrel (and was hurtling towards $55 a barrel) for the first time in 20 months.

Starbucks's quarterly net profit fell by 97% compared with the same period a year earlier. Before the economic crisis hit consumers' wallets, the purveyor of coffee was already suffering from overexpansion and is closing many of its ubiquitous stores.

Joining the job queue



America's **unemployment rate** in October hit a 14-year high of 6.5%. Meanwhile, **Circuit City**, an electronics retailer with 40,000 employees, sought bankruptcy protection. It is the largest American retailer to go bust since the start of the credit crisis.

In Britain the unemployment rate reached an average of 5.8% for the three months to September. **BT**, Britain's biggest telecoms company, said it was cutting 10,000 jobs. As the Bank of England delivered another glum outlook on the economy, the **pound** hit a six-year low of $1.49. See article

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KAL's cartoon

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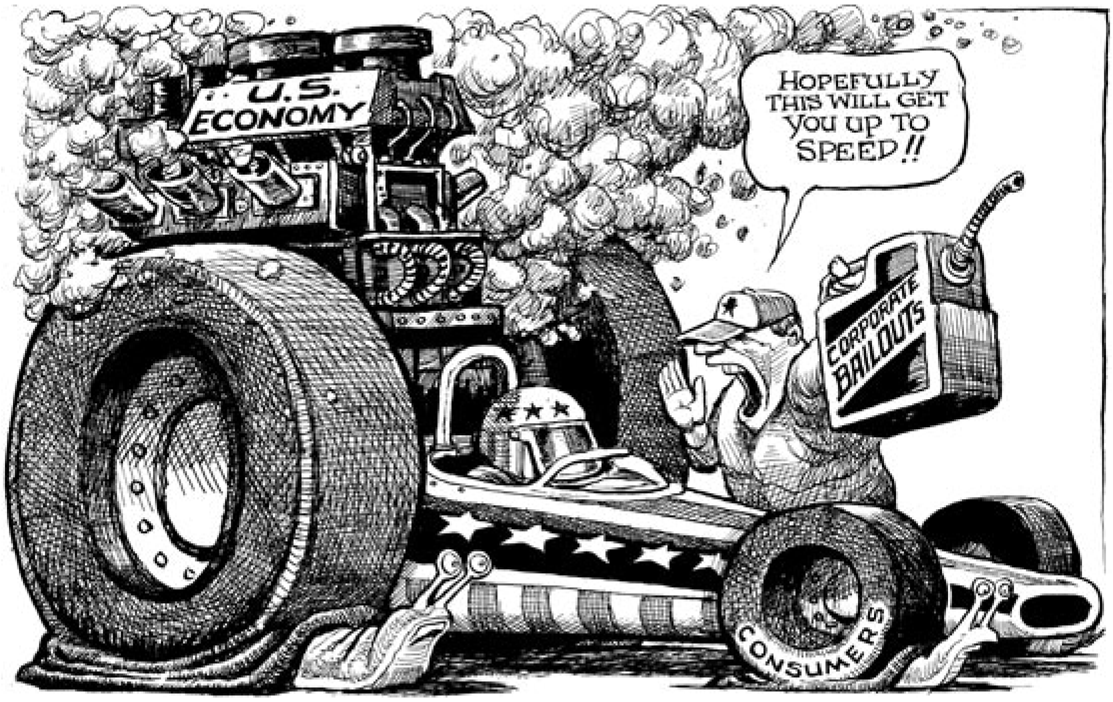
Illustration by KAL



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The world economy

Redesigning global finance

Nov 13th 2008
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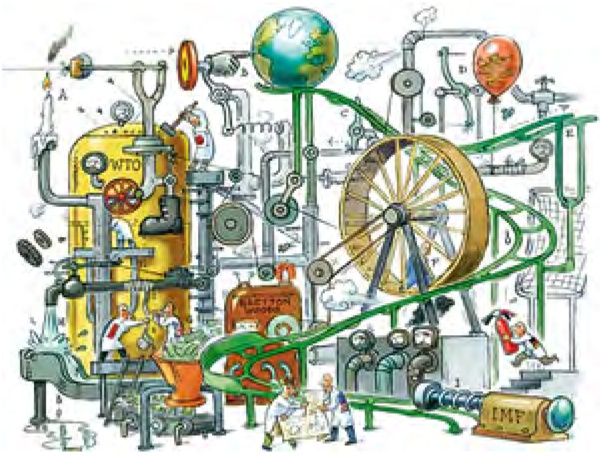
Government leaders cannot rewrite the rules this weekend. But they can still do some useful things



IT IS tempting to dismiss the upcoming G20 meeting as a piece of political theatre. Presidents and prime ministers from a score of rich and emerging economies will descend on Washington, DC, ostensibly to remake the rules of global finance. Several have talked grandly of a sequel to the 1944 Bretton Woods conference, which created the post-war system of fixed exchange rates and established the International Monetary Fund and World Bank. That is nonsense. The original Bretton Woods lasted three weeks and was preceded by more than two years of technical preparation. Today's crisis may be the gravest since the Depression, but global finance will not be remade in a five-hour powwow hosted by a lame-duck president after less preparation than many corporate board meetings. Yet for three reasons it is still a meeting worth having.

The first is that this could mark the beginning of a better multilateral economic system. The G20, created after the emerging-market crises a decade ago, is not perfect for today's problems. It excludes a big economy with an admired system of financial regulation (Spain) but includes a mid-sized country that has become irrelevant to global finance because of its own mismanagement (Argentina). Still, the G20 includes most of the key parts of the rich and emerging world, making it a better forum for global economic co-operation than the G7 group of rich countries, which has until now held the stage.

Don't just stand there

In the short term that co-operation, and this weekend's meeting, should focus on the second good reason for the Washington summit: crisis management. Although the panic in the credit markets shows signs of abating, the economic news gets ever grimmer. Global demand is slumping as rich economies plunge into what, collectively, could be their deepest recession since the 1930s. Pernicious deflation, though still unlikely, is no longer an idle risk (see article). Emerging economies are being hit hard by weakening exports and the collapse of private capital flows. The G20 summiteers cannot prevent this, but they can stave off a slump with zealous and co-ordinated action to prop up domestic demand and provide resources to cash-strapped emerging economies.

Some countries understand the urgency. China's stimulus plan, even if it is a little less dramatic than first trumpeted, is an important step (see article). Others, such as Germany, are being woefully timid (see article). A collective commitment by those who can afford it will pack more punch than individual initiatives. Useful too, would be a pledge to cushion the slump in private capital flows to emerging economies, through both central-bank swap lines and the IMF. Countries with ample reserves,

particularly China, Japan and the oil exporters, should promise now, and without preconditions, that they will lend to the IMF if it needs cash in the coming months. The G20 should also pledge its unequivocal support for free trade—a pledge that would gain credence if the leaders made a commitment to complete the Doha round of trade talks.

But what of the larger ambitions of "fixing" global finance? Here the temptation for hollow promises is greatest of all (see article). The summiteers can make progress, but only if they temper their hyperbole with realism and humility.

International finance cannot just be "fixed", because the system is a tug-of-war between the global capital markets and national sovereignty. As cross-border financial flows have expanded and big financial institutions have far outgrown their domestic markets, finance has become one of the most globalised parts of the world economy. At the same time, finance is inherently unstable, so the state has to play a big role in making it safer by lending in a crisis in return for regulation and oversight. Governments broadly welcome the benefits of global finance, yet they are not prepared to set up either a global financial regulator, which would interfere deep inside their markets, or a global lender of last resort. Instead, regulated financial firms are overseen by disparate national supervisors (in America they are sometimes state-based). The IMF helps cash-strapped countries, but the fund was conceived in an era when capital flows were restrained. It is puny relative to the size of global markets today.

This tug-of-war helped create today's mess. Disparate rules led to loopholes and "regulatory arbitrage". Many emerging economies sought to protect themselves against sudden outflows of foreign capital by building up vast foreign-exchange reserves. That fuelled the global credit bubble. Given today's crisis, the incentives to amass reserves have only grown.

The contradictory desires for national sovereignty and global capital markets limit the room for an overhaul. For all the grand rhetoric, no politician is proposing to cede sovereignty to a global regulator, let alone create a true global lender of last resort. Nor is anyone proposing a wholesale effort to curb capital flows (which is just as well). With no great design on the drawing board, it is better to concentrate on the more modest goal of improving the current muddled contraption through a series of politically feasible enhancements that together could amount to a third justification for this meeting.

Refit the existing engine

One example is Gordon Brown's idea of a "college of supervisors" to oversee the biggest financial firms. Another is a global set of norms on what should be regulated and how: from hedge funds to leverage limits, national regulators would do a better job if they acted in concert. By all means start to look at schemes to revamp the IMF by scaling back Europe's presence and enhancing emerging economies' clout. But it would be a mistake to rely only on the IMF. The Fed's new swap lines with other central banks are an important reassurance for countries that face a liquidity squeeze; those swap lines deserve to be systematised and broadened.

Modest as they sound, such repairs will be difficult and time-consuming. This summit should get them off to a start. It won't earn anyone a place in the history books alongside John Maynard Keynes and Harry Dexter White. But it would be a lot more useful than more gusts of grandiose rhetoric.

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Economist.com OPINION LEADERS

China's fiscal stimulus

Dr Keynes's Chinese patient

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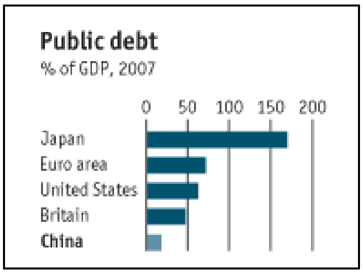
There may be less to China's fiscal-stimulus package than meets the eye; but it is still hugely welcome



ASKED what China will do to rescue the world from financial turmoil, its officials these days have a boilerplate answer: its "greatest contribution" will be to keep its own economy running smoothly. It is tempting to dismiss this trite formulation as a meaningless excuse for inaction. For two reasons, that would be a mistake. First it is broadly speaking true. Continued rapid growth in China can do much to mitigate the rich world's recession (see article). Second, the announcement this week of a massive fiscal-stimulus package suggests the government does intend to do what it can to keep its own economic engine purring.

The stimulus may turn out to be much smaller than the headline figure of 4 trillion yuan ($586 billion) over two years, which at some 14% of annual GDP would perhaps be the biggest peacetime stimulus ever. The vague announcement may include large sums already earmarked in the budget. Its ten-item list of priorities covers everything from grain-procurement prices (up) to the corporate-tax burden imposed by VAT (down), taking in infrastructure, post-earthquake reconstruction, health care, education and environmental protection.

Yet even if this list reads like a national letter to Santa Claus, the package is still a giant step in the right direction. It shows that China's leaders have grasped the dangers, that they have the fiscal and borrowing scope to tackle them, and perhaps most important that they are sending a political signal of their readiness to do so. An economic slowdown is already under way in China and could worsen next year. After years of double-digit expansion, even 6% annual growth feels like a hard landing and will exacerbate social tensions (see article).

China's own leaders believe they need growth of at least 8% a year to avoid painful unemployment—even this year, thousands of smaller firms have gone bust. They are right that spending on infrastructure and on measures to encourage domestic spending is among the best ways to sustain growth. China is not Japan in the 1990s, littered with bridges to nowhere. It is still a poor country where rail and road networks have much room for improvement—if that is indeed how the money is spent, rather than on lavish town halls and other "monuments" to corrupt local officials. Moreover in directing money to the poor and into the health and education systems, the package may help unwind the grotesque global distortion that has seen poor Chinese farmers' savings in effect help finance the debt-fuelled excesses of Western consumers.

Give them pensions, health care and land, not T-bills

If the 800m in China's countryside are persuaded to spend their money rather than save it, stronger domestic consumption could give a big boost to an economy still skewed towards exports. But the government seems half-hearted in this structural shift: it has also announced a raft of measures to subsidise exports. And it is doing too little to ease the worries that make China's people cling on to their cash: how to meet unexpected medical bills; how to pay for a good education for their children; how to provide for their old age. Government health spending especially, at less than 1% of GDP, is woefully low—and not tackled meaningfully in this package.

Nor is there anything to bring forward the other reform that would do most to raise rural incomes: giving farmers stronger rights over their most valuable asset, the land they farm. Short, usually 30-year, leases give them little security, and they cannot mortgage them to raise money. The Communist Party last month unveiled a "new" policy on landholdings. It was a damp squib. Global financial turmoil should encourage it to produce some fireworks.

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Economist.com OPINION LEADERS

Protecting the vulnerable

What Congo means for Obama

Nov 13th 2008
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America's president-elect needs to remake the case for humanitarian intervention abroad

Reuters

IN AMERICA this has been a week for the drawing up of lists—lists of the virtues of Barack Obama, lists of big names for his administration, lists of big tasks for his bulging in-tray. But in Congo this week a million hungry and terrified refugees are in desperate need of food and protection (see article). The two things are connected, in a way that may surprise, and dismay, Mr Obama's admirers. If he is to prove worthy of the near-universal exaltation with which his election has been greeted, he has to prepare America and the world for the possibility of further American military interventions overseas.

This is not to say that it is America that has to provide the 3,000 extra peacekeeping troops the United Nations has asked for in Congo. The French have troops available, and America is in no mood for new entanglements. With an overstretched army and an economy on life support, most Americans reckon this is a time to rebuild at home, not embark on new adventures in far-flung places. Most foreigners probably agree. In their eyes, George Bush's wars were a disaster, if not a crime. They think that whatever Mr Obama says about winning in Afghanistan, he was elected to practise war no more.

A lovely sentiment. The trouble is that history does not take a holiday just because America needs a breather. Mr Obama will sooner or later face a question that has plagued all recent presidents. Forget about wars launched in the name of defeating terrorism, stopping nuclear proliferation or pursuing some other direct American interest. What should the world's strongest and (still) richest country do when famine or conflict strike places whose own governments will not or cannot help, where America has no direct interest, but where averting a humanitarian disaster may require military intervention?

The answers of previous presidents have depended on temperament and circumstance. George Bush senior sent marines to feed Somalia. Bill Clinton used force to stop the ethnic cleansing in Kosovo but not in Rwanda, where Hutus killed close to 800,000 Tutsis. The junior Bush decided against intervention in Darfur, even though his own administration called the ethnic cleansing there a genocide and the killing goes on.

It remains to be seen where Mr Obama's temperament will lead, but it is easy to see how circumstances might dull any appetite for intervention. It is not just that America is stretched thin; the Bush years have also damaged the intellectual case for intervention. America did not invade Afghanistan and Iraq out of altruism, but those wars have shown how hard it is to rebuild broken countries. Congo itself is an example; even with the UN's biggest peacekeeping operation it is still in danger. For several years *The Economist* has repeated like a stuck gramophone needle a call for intervention in Darfur, but we acknowledge the law of unintended consequences. In all such cases, the use of force should be the very last resort.

And yet a strong moral case remains for forceful outside intervention in desperate cases. Would the world still do nothing if it had a second chance to avert genocide in Rwanda? And the practical case is stronger than the failures suggest. From the Balkans to Liberia to Sierra Leone to Kosovo, armed intervention has, on balance, helped to end or forestall catastrophes. Though imperfect, the UN operation in Congo has helped to end a war that killed millions: it should be reinforced immediately, preferably by troops from Europe, not local ones. Too often in Congo, neighbours promising help stay to plunder.

Two jobs for a new president

As for Mr Obama, he has a chance to restore America's moral leadership. That is not something he should do by scouring the world in search of new monsters to slay. Nor, though, can a war-weary America turn its back on people threatened by ethnic cleansing or genocide. Since 2005 the UN has accepted a responsibility to protect people in such cases, so this is not a burden for America alone. But since the UN has no army, and no other countries have the military resources America boasts, there may be times when only the superpower can move soldiers swiftly where they are needed.

Should that call come, Mr Obama will need the courage to respond, notwithstanding Americans' fatigue. In extremis, if the danger is great and veto-wielding members of the Security Council block the way, he and others might have to act without the Security Council's blessing, as NATO did in Kosovo. Far better would be an early effort by Mr Obama to reach agreement on the rules to apply and forces to earmark so that the UN can actually exercise its collective responsibility to protect. That will be hard, but Mr Bush was actively hostile to such work. How fitting if the next president made possible a genuinely global response to the next Rwanda, Congo or Darfur.

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Carmakers

Saving Detroit

Nov 13th 2008
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Politicians, business and the unions all want a bail-out of Ford and General Motors. That would be a mistake

Getty Images

DETROIT is running on empty. General Motors and Ford announced on November 7th that they had burnt their way through a total of nearly $15 billion of their precious spare cash in the third quarter. GM is on course to run out of money early next year; Ford a little later. Chrysler, 80% owned by Cerberus Capital, a private-equity firm, is less open about its suffering. But most people think it is already roadkill (see article).

Across American industry, politics and labour, rarely have so many been so united: Detroit needs saving. The carmakers think they need $50 billion of taxpayers' support to see them through. At a time when the government is throwing more than $1 trillion at the financial system, isn't that only fair? Indeed, if it saves millions of jobs isn't it a bargain? You never know, the state's investment might even turn a profit.

Bailing out Detroit would be a bad use of public money. It would be bad in principle, because it would be an open invitation to companies everywhere to apply for aid to survive the recession. Banks qualify for help because the entire economy depends upon their services. They are vulnerable to sudden collapses in confidence that can spread to other banks that are perfectly solvent. A good car company does not face the same threat. And although Detroit employs a network of suppliers, which would suffer if production shuts down, nothing would sap a recovery and job-creating enterprise like locking up badly used resources in poorly performing companies.

America's carmakers accept the principle, but they argue that in practice they too are a special case. After years of cutting capacity and renegotiating their costs with the unions, the carmakers argue that they are within a whisker of better times: with one last shove from the taxpayer, it will be alright.

There is something to this—but not because of what is happening in America. As our special report explains, the global car industry is shifting from the saturated markets of rich countries to the huge potential of fast-growing emerging markets. As recently as 2005, America bought 10m more cars than the total of the BRICs—Brazil, Russia, India and China. This year, sales of cars in the BRICs should overtake those in America.

Despite slower economic growth in emerging markets, there are reasons to think car sales will remain strong. America has nearly one car for every person of driving age; China has fewer than three cars for every 100 people and India fewer still. Once people have a roof over their heads, meat on the table and a good job, the next thing they want is a set of wheels. In the next 40 years, the world's fleet of cars is expected to increase from around 700m today to nearly 3 billion.

Some greens and pedestrians may find that a terrifying prospect. But for today's embattled carmakers it is an extraordinarily exciting one—and that includes the giants from Detroit. GM has been as nimble abroad as it has been flat-footed at home, an early-mover in China, Brazil and Russia, it holds strong positions in all three markets. Ford is not far behind.

The next Chapter

But is that justification for a bail-out? Not at all. The United States created Chapter 11 precisely to help companies that need protection from their creditors while they restructure their liabilities and winnow out the good business from the bad. If the North American businesses of GM and Ford filed for Chapter 11, their activities elsewhere would be largely unaffected. Even in North America, their businesses could continue to make vehicles as they shed costs and renegotiated contracts.

The carmakers retort that being in Chapter 11 will poison their business. Buying a new car is a long-term gamble on there being dealers, spare parts and a thriving second-hand market for your vehicle. Drivers overwhelmingly tell surveys that they would not take the risk when Mercedes and Toyota make perfectly good alternatives. But $50 billion is a lot to stake on a hunch. A wiser bet is that whatever consumers say today, the stigma of being in Chapter 11 would fade, obscured by price cuts, advertising and most of all news that the car companies were tackling their remaining problems. Remember that, in many ways, Chapter 11 is more stable and predictable than depending upon the government.

That is an unpopular message. It is almost certain to be ignored by Congress, which is itching to "save jobs" and to counter the public-relations disaster of bailing out Wall Street. If the state is determined to keep the industry out of Chapter 11, it should set up a special fund and demand preferred equity to deter shareholders in other industries from asking for money. But it would still do better to let the car firms fail.

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Economist.com OPINION LEADERS

A modest proposal

O give me a home...

Nov 13th 2008
From The Economist print edition

The Maldives' president has come up with a solution to the world's problems

Rex Features

LOSING one's home is a sadly common experience in these dark economic days, but it normally happens at an individual, rather than a national, level. The residents of the Maldives, however, face collective homelessness as a result of rising sea levels, which are expected eventually to engulf the 1,200-island nation, whose highest point is 2.3 metres above sea level. Faced with this alarming prospect, the country's new president, Mohamed Nasheed, has come up with an equally dramatic solution: put aside some of the Maldives' tourism revenues to buy another homeland.

At first blush Mr Nasheed's notion seems a bit over the top. Countries don't usually go round purchasing large lumps of other nations. The only precedent he cites—Jews buying up bits of Palestine before Israel was established—does not inspire confidence that his plan would increase world harmony. And since the rich countries that caused the climate to change and the seas to rise can easily absorb the Maldives' 370,000 people, it seems reasonable to assume that Mr Nasheed and his compatriots will be offered citizenship elsewhere.

The empty quarter beckons

Reasonable, but wrong. Australia's government has already turned down a request to offer citizenship to the 12,000 people of Tuvalu, another small, drowning island; so a few hundred thousand Maldivians knocking on rich-country doors seem likely to get even shorter shrift. Anyway, they may not want to be absorbed into a larger nation. They might prefer to stay together to maintain their community spirit and traditions of folk-dancing and imprisoning political dissidents. So a solution as radical as Mr Nasheed's may be the only answer.

It's a buyer's market in property these days; and, if the Maldivians are looking for an island, Iceland is said to be going cheap. But they may be spoilt for choice: think of all the tiresome bits of territory that other countries would like to offload. The snooty English, for instance, have long disparaged Wales, which they caricature unfairly as being populated mostly by Methodist preachers and disaffected sheep. It might be a challenge to persuade the Maldivians to swap their palm-fringed paradise for Llandudno pier on a wet Sunday afternoon; still, a bit of adroit marketing, focusing on the height of the hills, Catherine Zeta-Jones and Anthony Hopkins (both sadly no longer resident) might do the trick.

Once Mr Nasheed's visionary notion gains acceptance, it could have far wider application. The Israelis, for instance, could put an end to a hundred years of futile hostilities by buying somewhere for the Palestinians. If they clubbed together, they could get somewhere really nice—Florida, maybe. China could stop making aggressive gestures towards Taiwan and buy Malaysia instead. It's already run by Chinese, so they'd hardly notice the difference. And Barack Obama, committed to uniting America, could defuse

the nation's culture wars by purchasing an alternative homeland for those of his countrymen who want more use of the death penalty, less gun control and no gay marriage. A slice of Saudia Arabia's empty quarter would do nicely: there's plenty of space and the new occupants would have lots in common with the locals.

The British are familiar with the notion that, if you're bored at home, you grab somebody else's country; but recent experience suggests that invading places can be expensive and troublesome, so a market solution seems a better way of dealing with national dissatisfaction. The British are, let's face it, fed up with their damp little country. Instead of renting villas in Tuscany, they should buy the place; instead of complaining about the weather, they could complain about Silvio Berlusconi. The Russians suffer from too much crime and too much snow; the Gulf Arabs from too much heat and too little fun. Both should think of buying a temperate, orderly city with decent nightlife, such as London. Wait a minute...

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Economist.com OPINION LETTERS

On our endorsement of Barack Obama

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From The Economist print edition

Hail to the chief?

SIR – The reasoning behind *The Economist*'s endorsement of Barack Obama for president ("It's time", November 1st) was inconsistent with past leaders. Your endorsement argued, for instance, that an Obama presidency would make it "far harder for the spreaders of hate in the Islamic world" to denounce America, which somewhat contradicts your belief that "the Middle East will not heal, just because a president's second name is Hussein" ("But could he deliver?", February 16th).

That same leader questioned Mr Obama's leadership abilities, asserting that "a man who has never run any public body of any note is a risk", a theme you returned to when you said Mr Obama "has never exhibited political courage" ("The hard road ahead", August 23rd). Little else has changed since you were "appalled by some of the anti-capitalist rhetoric he…has spouted" and worried "about his strategy for leaving Iraq" ("Almost there", May 10th).

You once stated that "policies are by no means the whole story of an American election: character and leadership matter greatly, too" ("The hard road ahead"), yet it seems character was ultimately the sole deciding factor for you. This was an endorsement for a charismatic figure with very little experience, and came despite your suspicion "that he is too far to the left". Such a candidate should not be good enough for *The Economist*.

Andrew Stein
Washington, DC

SIR – Your endorsement was the most baffling article I've read in the 20 years that I have studied and trusted your publication. Eschewing your impeccable logic, you spent nearly the entire leader correctly, even apologetically, identifying the reasons why Mr Obama is unfit for the presidency, then brushed them aside to say "take a chance" and vote for him anyway.

John Rollins
Tallahassee, Florida

SIR – Yes, Mr Obama ran an "exceptionally assured" campaign, but running an embattled superpower is a bit different than criss-crossing the nation in a private jet adorned with a campaign logo. Once the glamour-adulation machine is turned off, what will we be left with? You saw the signs.

James Thomas Palazzolo
Ann Arbor, Michigan

SIR – For a publication that purportedly supports free trade and capitalism it is distressing that you would endorse a candidate that has openly railed against both. Your supposition that Mr Obama has veered to the centre during the campaign and will thus govern that way defies the existing evidence.

I subscribed to *The Economist* to escape the intellectually dishonest, biased news media that prevails in the United States, but it turns out that Mr Obama's star power is universal. Welcome to the Obamaite bandwagon.

John Beauchamp
Gainesville, Florida

SIR – I have watched with considerable interest over the past 22 months as you slowly, grudgingly, moved away from John McCain and towards Mr Obama. I am delighted that you finally got it right.

James Taylor
San Clemente, California

SIR –America’s election laws prohibit foreigners from contributing to the campaigns of elected officials. By publishing your endorsement before the election, you attempted to influence the electorate in a way that has far more impact than contributing money. You have, in effect, violated the spirit and intent of American law. Your European welfare-state mentality inevitably biased your conclusions. Americans are a centre-right people, whereas Britain is at best left-centre (word order is paramount here).

Doug Baker
Fenton, Missouri

SIR – In one respect your endorsement of Senator Obama is not a surprise. Since 1980 your endorsements have displayed a clear anti-incumbency bias. Except for two elections in which you chose not to back a candidate, you always endorsed the nominee of the opposition party. So the more startling choice would have been the endorsement of Senator McCain.

João Luis Hamburger
São Paulo

SIR – I cannot tell you how offended I was by your line that Mr Obama’s election would “lessen the tendency of American blacks to blame all their problems on racism”. The implication that we are a collective group of whiners and your dismissal of the realities of American racism is shameful. Where is the research showing that blacks really do “blame all their problems on racism”? You demonstrated a “tendency for whites” to blame the consequences of racism on blacks.

As a group, blacks suffer disproportionately from racial disparities in health, education, housing, income and employment. The idea that Mr Obama’s election will somehow diminish the truth of that situation is oversimplified. Please continue your reporting on the economy, but leave analysis on race to those with actual expertise and background in such matters.

Khadijah White
Philadelphia

SIR – The opportunity to yet again bewail the disappearance of the “real” John McCain was obviously too good for you to pass up. You implied that the self-proclaimed maverick ended up trusting his advisers way too much. The source for the term “maverick” is Samuel Maverick, a 19th-century pioneer in Texas who left his calves unbranded. This was unconventional at the time because whoever found the calf could appropriate and sear it with his own brand. One way or another, this quaint meaning of “maverick” seems to capture the “real” Mr McCain pretty well.

Ranko Bon
Motovun, Croatia

SIR – As pundits rush to put Mr Obama’s victory into historical perspective, too little attention has been paid to the immense political courage of Lyndon Johnson in pushing through civil-rights bills in the 1960s, the passage of which he knew would result in the Democrats losing the South “for a generation”. Since an African-American president would have been highly unlikely without this legislation, Mr Obama’s election is therefore a massive tribute to Johnson’s memory, as is the Democrats’ associated, if belated, success in rediscovering the “lost South” with electoral progress in states such as Virginia and North Carolina.

David Docherty
London

SIR – In his “two cheers for American democracy”, Lexington pointed to the rise of Mr Obama, whom he described as “the son of a couple of nobodies” (November 1st). Actually, Mr Obama’s father got a degree from Harvard and went on to become an economics adviser to newly independent Kenya.

Mr Obama’s mother had a career in international development and earned a PhD. Mr Obama’s grandmother was one of the first women to become a vice-president at Bank of Hawaii. Whatever you may think about Mr Obama’s atypical family, they were certainly not “nobodies”.

Joel Heinen
Miami

SIR – I would like to congratulate Mr Obama on his brilliant victory. In his official capacity as president of the United States he will probably have to meet our prime minister, Silvio Berlusconi. I apologise in advance.

Marta Sanna
Cagliari, Italy

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The global economic summit

After the fall

Nov 13th 2008
From The Economist print edition

On November 15th world leaders are due to sit around a table in Washington, DC, to fix finance. They have their work cut out

Illustration by Bill Butcher

THE leaders arriving in Washington, DC, for this weekend's economic summit are being presumptuous. If they want what they are calling Bretton Woods 2 to live up to the original, which took place in New Hampshire overshadowed by war and the Depression, it will have to establish a new economic order for the capitalist world. In 1944 that meant creating the IMF, the World Bank and a body to oversee world trade. Imagine Hank Paulson, America's treasury secretary, as John Maynard Keynes; or picture Gordon Brown, Britain's prime minister, as Winston Churchill (as Mr Brown himself secretly may), and you get a sense of the task ahead.

The Bretton Woodsmen of 2008 are grabbing the credit before they have earned it—rather as all those subprime householders did. More than two years of gruelling technical work laid the ground for the wartime conference of officials and finance ministers (prime ministers and presidents had other things to deal with). By contrast, the leaders gathering this weekend from the G20, a mix of industrial and emerging countries, plus the European Union, have cobbled together an agenda in a few frenetic weeks. They will doubtless produce no shortage of promises. Just what these are worth will depend on sweat and summits yet to come.

The summit is sure to stir up a debate about the institutions that oversee the international economy. By convening the G20 rather than the closed, rich club of the G7, the old order has in effect acknowledged that the rest of the world has become too important to bar from the room. But what new order should take its place? Answering that question has been a parlour game for economists since long before the crisis. By encouraging them to dust off their pet ideas, the summit will at the very least create a bull market in new schemes for global economic governance.

Because everyone agrees that something big needs fixing and that the world expects action, calling the summit Bretton Woods 2 could yet come to be seen as a rallying cry for reform. And yet there are lots of reasons to see it as vainglory. The agenda is vague and sprawling. With so many of the world's political leaders sitting around the table, it will be hard to escape platitudes and hypocrisy. There may be disagreements—especially where sovereignty or competitiveness is threatened. And most of all, the recent international financial collaboration is fraught with in-fighting and complexity.

At first sight, this summit seems no different. For instance, consider how Mr Brown and Nicolas Sarkozy, the president of France, have vied to claim paternity of the summit for their own domestic reasons. Mr

Sarkozy sees a chance to show he is a man of action, and he will find it easier to force through domestic reform if he can show he is not in thrall to all that Anglo-Saxon free-market ideology.

Mr Brown has been calling for a global summit for weeks, emboldened by international acclaim for his plan to rescue Britain's banking system. The prime minister is keen to show that the crisis is one of those worldwide messes that—honestly—has nothing to do with the past 11 years of Labour government. And he wants to play the lead in Washington so as to protect the free-market City of London from the Gallic machinations of Mr Sarkozy.

From despair, hope

But there is more to the summit than politics. Perhaps inevitably, the run-up to the summit has produced dozens of different proposals. Broadly, they fall into three areas. First and most urgent is the need to limit the crisis, which is even now spiralling from the rich world to emerging economies. Second is financial regulation: its flaws have been laid bare, and the summiteers will want to put it right. Third is global macroeconomics. The G20 needs to find ways to correct the imbalances—Asian saving and Western spending—that lay behind the boom.

Pervasive economic gloom is the best reason for hoping that something important will come of this weekend's meeting. After savaging the financial markets, the credit crisis has broken loose into the real economy. This month the IMF lowered its forecast for global growth next year by 0.8 percentage points, to 2.2%. The rich world is already in recession. Unemployment, foreclosures and corporate bankruptcies are rising. Emerging economies have also been ensnared, as investors from richer countries retreat to their home markets. The fund cut its forecast for their growth rate by a percentage point, to 5.1%.

Such pain demands an ambitious policy response. On November 6th Kevin Warsh, a governor of the Federal Reserve, put it in dramatic terms: "We are witnessing a fundamental reassessment of the value of every asset everywhere in the world," he said. "The establishment of a new financial architecture, thus, is the essential policy response to the greatest economic challenge of our time."

The easy bit will be to harness that sense of urgency to produce concerted interest-rate cuts and government spending. Already, several countries are talking about a co-ordinated fiscal stimulus to help offset a collapse of private-sector demand. China set the standard on November 9th, with a huge spending plan worth 4 trillion yuan (nearly $600 billion), or about 15% of GDP (see article). Not everyone can muster such resources, but other countries, including America and Britain, are preparing to act too. Germany, which has promised a piffling €12 billion ($15 billion), may be shamed into spending more. With concerted action, countries will find that each national stimulus buys more confidence than it would do alone.

Many commentators also want to build confidence by increasing the spending power of the IMF. If a large emerging market, such as Poland or Turkey, were to need help, says Willem Buiter, an economist at the London School of Economics, its present resources of $250 billion "would be gone before you can say 'special drawing rights'." Although some European delegates want to strengthen the IMF, the Americans are resisting: the summit may produce nothing more than a pledge to find the money if the fund needs it.

In financial regulation, some changes ought to be easy to agree on—such as ensuring that banks stop holding assets off their balance-sheets and put capital aside against possible failures in a wider range of securities. The summit is also likely to try to bring order to the market for credit-default swaps, which trade the risk that borrowers will not honour bonds, by concluding that, within 120 days, the business should be routed through clearing houses rather than settled privately by investors.

That is progress, to be sure. But it is small potatoes next to the summiteers' ambitions. And little else will be easy, even if the leaders can issue a declaration that sets out their common principles and a schedule of negotiations for further reform. To see why, leave behind the first Bretton Woods conference for the more recent history of international financial regulation.

No end of squabbles

Illustration by Bill Butcher

The difficulty with cross-border rules in finance is explained by Barry Eichengreen, a professor at the University of California, Berkeley, and one of 20 economists from around the world who have written

an "e-book"* that describes what this weekend's summit should do.

On the one hand, finance is every country's business. This crisis has shown that what happens deep inside one national financial system can wreck another halfway across the world. In the United States subprime lending was a relatively small bit of the mortgage market—itself just a part of America's financial markets. And yet the cascade of failing credit and risk aversion that began there, partly as a result of inadequate supervision, has spread not just to the overstretched banking systems of Europe, but also now to untroubled banks in emerging markets.

On the other hand, nation-states jealously guard the right to oversee their own banks. This is not just out of principle, or a desire to see that the regulations suit their own financial institutions—although most regulators would think these alone to be sufficient reason. It is also because, when a crisis comes, the nation-state foots the bill for a bail-out. In addition, Wendy Dobson, of the University of Toronto, notes that regulators need intimate local knowledge of their charges and their own financial structures if they are to have a hope of prevailing—and even then, as the world has seen, the odds are against them.

The tug between national and supranational regulation has gradually led to an ad hoc arrangement for the international banking system. In the 1980s America and Britain grew worried about the expansion of Japanese banks, which by 1988 accounted for nine of the world's ten largest by assets, up from one at the start of the decade. What bothered the West was that Japanese regulators allowed their banks to count shareholdings as core capital. Cheap capital fed their growth. And it was indeed reckless, as the subsequent collapse of the Japanese stockmarket showed.

Under the auspices of the Bank for International Settlements (BIS), a central bankers' central bank in Basel, in Switzerland, the big economies agreed to set common standards for what counted as capital and how much a bank should hold in order to qualify as safe. Their negotiations were partly about rules to make the global financial system more resilient. But they were also, in effect, about a trade dispute, over what the West saw as a subsidy to Japan's banks. This ambiguity between the common good and national interests complicates all financial negotiations—including any that will follow the G20 summit.

Andrew Gracie, who worked on regulatory design at the Bank of England and founded Crisis Management Analytics, which advises central banks on financial stability, points out that right from the start regulators looked at systemic risk one bank at a time. The assumption was that if each institution was safe, then the system as a whole would be too. Similarly, when banks had many subsidiaries, regulators short of money and time tended to worry only about their own piece of the jigsaw.

This "micro-prudential" philosophy was always questionable. Now it looks absurd. Banks tend to own similar assets. In a crisis the capital of the entire industry tends to fall, which means that the instability of one bank can undermine the standing of the next. Hence the talk about a new "macro-prudential" sort of regulation that seeks to take account of the whole system's vulnerabilities, as well as the health of individual banks, by, say, adjusting capital charges over the economic cycle.

The strengths of the original Basel standards (Basel 1) lay in being reasonably simple to negotiate and administer. But therein lay their weaknesses also. Banks soon started to favour business that was profitable (ie, risky) but which, under Basel 1's crude definitions, escaped the appropriate capital charges. As the banks adapted to Basel 1, so the rules became less useful.

That gave rise to the effort to create Basel 2, which began in the late 1990s. This sought to strike a different balance, by asking banks to be more sophisticated in assessing the riskiness of their assets and thus their capital requirements. But sophistication came at a high cost. A recent book† by Daniel Tarullo, a professor of law at Georgetown University who is fancied for a senior economic post under Barack Obama, describes how the negotiations dragged on for years as governments jostled for a deal that would give their own banks some advantage. Mr Tarullo observes that the banks would accept all sorts of arbitrary provisions as long as the end result was to reduce the amount of capital they had to put aside.

Faults and lessons

Basel 2 is a flawed agreement. Although it is not yet in force, it already needs updating. Its chief failing is its reliance on rating agencies and the banks' own models of the risks that they are carrying—an idea that has been discredited by the way banks have been caught out. In addition, the accord did not allow for the evaporation of liquidity that prevented the banks from financing their businesses. It is hardly reassuring that the minimum capital that rescued banks are aiming for today is far above the minimum set by Basel 2.

The story of bank-capital standards contains important lessons for the leaders gathering at the G20. The talks dragged on because their objectives were unclear, the subject matter was complex, negotiators were fighting for the upper hand and there was little sense of urgency. Even if all that can be put right, the schedule of work has expanded. Supervision may need to extend beyond banks, to any financial institution whose failure could threaten financial stability, which might include some large hedge funds and non-bank financial companies such as GE. The capital-standards regime also needs to become more macro-prudential. Regulators need to be able to put more trust in banks' risk models and rating agencies and supplement them with simple rules about the level of borrowing. Mr Tarullo suggests that banks should issue new securities to serve as gauges of investors' faith in them.

There are two difficulties in all this. The first is that it will take time and, as urgency fades and the negotiators drown in complexity, national interest may gain at the expense of collective safety. The second is that original dilemma: international rules require enforcement, but nation-states demand sovereignty. Dominique Strauss-Kahn, head of the IMF, wants an inspectorate. Mr Eichengreen has proposed a World Financial Organisation, with disciplinary panels. The EU wants "colleges" of national regulators for each bank and an IMF to give warning of crises. The summit looks most likely to back the EU idea—but it ought to be more ambitious. The system will work only if governments heed outside warnings. But just look at how they browbeat the IMF into giving favourable assessments of their economies.

Although this summit looks likely to dwell on financial regulation, it cannot ignore the macroeconomics that preoccupied the original Bretton Woods conference all those years ago. As Martin Wolf, a columnist at the *Financial Times*, explains in a new book‡, the boom was fuelled by the imbalances that grew out of the Asian financial crisis in 1997.

Illustration by Bill Butcher

Countries that had grown used to incoming foreign capital suffered terribly when it suddenly flowed back out again. To protect themselves in future, they started to run current-account surpluses and to amass foreign-exchange reserves. Spendthrift America and Britain were happy to help Asia save, even if that meant running the corresponding deficits.

Surpluses are all very well, but they cannot continue to accumulate for ever. Perversely, if they unwind violently, they will create instability. Much of the cheap money recycled from the saving countries found its way into housing and other assets in the West. It was too much to hope that it would flow back out of those assets in an orderly way.

The conflict between sovereignty and safety here is even less easy to disentangle than it is in financial regulation. Clearly, no country would agree to live by a rule that it should balance its current account.

Raghuram Rajan, a professor at the University of Chicago and a former chief economist at the IMF, points out that current-account surpluses and deficits can indeed help countries cope with shocks and finance investment. At the same time, no international organisation like the IMF could plausibly have the independence or the resources to make a credible promise to back all the economies suffering from capital flight in a crisis.

This conundrum leads straight back to a souped-up IMF—still too small to save the world, admittedly, but bigger than today's, and backed by swap lines from the three large regional central banks, the Fed, the European Central Bank and eventually the People's Bank of China. For that to work and for the IMF's help to lose some of its stigma, rich countries will have to admit more emerging economies to the fund's board. Cue yet more difficult negotiations.

There are two ways of thinking about this weekend's summit in Washington. To be charitable, look on and wonder at the sheer ambition of taking on so many hard, important questions. A severe financial crisis may be the only time when the technicalities wallowing near the bottom of policymakers' agendas receive the attention they deserve. But there is a more cynical interpretation. Perhaps the summiteers will bask in the headlines and then, out of the glare of the television lights, set about something disappointingly modest.

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* "What G20 Leaders Must Do To Stabilise Our Economy and Fix the Financial System", edited by Barry Eichengreen and Richard Baldwin. Available at www.voxeu.org/index.php?q=node/2543
†"Banking on Basel: The Future of International Financial Regulation". Peterson Institute for International Economics, August 2008.
‡"Fixing Global Finance: How to Curb Financial Crises in the 21st Century". Johns Hopkins University Press, September 2008; Yale University Press, forthcoming.

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The presidency

Change.gov

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From The Economist print edition

The transition to a new administration is already well under way

EPA

HAVING fought the longest election campaign in American history, Barack Obama is now immersed in the most difficult transition in living memory. He will inherit two wars and the worst economic crisis since the Depression. He needs to ensure a smooth transfer of power from an incumbent who is ideologically and temperamentally his polar opposite. He also needs to translate his vague philosophy of “hope” and “change” into governance. Hearts are sure to be broken and enemies made.

Mr Obama is bringing the same talent for organisation to the transition that he brought to his campaign. He has been quietly planning since the summer with John Podesta, a former White House chief of staff to Bill Clinton and the head of a Clintonian think-tank, the Centre for American Progress, studying previous transitions and mulling over appointments. And he announced an expanded transition team the day after winning the election, adding Valerie Jarrett, a veteran Chicago insider, and Pete Rouse, his chief of staff in the Senate. So far the troika’s approach has been thoroughly businesslike, with remarkably few leaks (particularly for Democrats) and a firm focus on getting things done quickly but not hastily. Mr Podesta has suggested that, given the gravity of the country’s problems, Mr Obama will try to announce several cabinet appointments, particularly the treasury secretary and the national security team, before December. But rumours that he would do so within days of the election proved to be exaggerated.

Mr Obama’s planners are heavily influenced by two previous transitions—Bill Clinton’s in 1992-93 and Ronald Reagan’s in 1980-81. They are determined to avoid repeating the mistakes that Mr Clinton made and that many of them lived through. He was slow off the mark, failing to make a single senior appointment for six weeks after he was elected and indulging instead in endless waffle. He focused on cabinet appointments rather than on the White House staff (many of the White House staff were not announced until just before Christmas). He was obsessed by questions of “diversity”, needing three attempts to name an attorney-general, for example. He annoyed key figures on Capitol Hill. And he became embroiled in a damaging argument about gays in the military. Many Clinton veterans now claim that this led inexorably to chaos in the White House, squabbles with Democratic power-brokers and the Republican takeover of Congress in 1994.

They are determined instead to follow Reagan’s model. The Reaganites not only grasped that the engine of power for the administration is the White House staff rather than the cabinet. They also understood the importance of hitting the ground running. Mr Obama’s planners are even imitating some of the fine details of Reagan’s approach: by collaborating so closely with the Centre for American Progress, they are echoing the way in which Mr Reagan worked with the then relatively new Heritage Foundation.

This has allowed Mr Obama to get off to a decent start. Two days after he announced his expanded

transition team he also made an important White House appointment: Rahm Emanuel to be his chief of staff. This suggests a clear grasp of priorities. The chief of staff acts as the president's gate-keeper and principal enforcer. He is also soon expected to announce Robert Gibbs as his press secretary, the position that comes with the biggest megaphone in Washington.

Mr Obama's choice of his chief of staff is smart. Mr Emanuel has a remarkable combination of experience in both the executive and the legislative branch: he was an adviser to Mr Clinton as well as the mastermind behind the Democratic takeover of Congress in 2006. He is also a hard-ass—an expletive-spouting dynamo who can keep the trains running on time and malcontents cowering in their caves (he is nicknamed "Rahmbo", and he once sent a dead fish to somebody who crossed him).

The Republicans immediately objected that Mr Emanuel's appointment undermined Mr Obama's promise to bring a new kind of politics to Washington. But Mr Emanuel's main job will be to keep his former colleagues on the Hill in line, not to worry about the opposition. He is a Clintonian centrist who has championed welfare reform, free trade and even a slightly flatter tax code. He has been close to his fellow Chicago pol for years. And he is the ideal bad cop to Mr Obama's good cop.

To his credit, George Bush is also putting a lot of effort into making the first transition since September 11th 2001 go as smoothly as possible. He has created a "co-ordinating council" populated by experts from both outside and inside the administration. He is requiring even third-level staff to prepare detailed briefing books. He has followed the 9/11 commission report's recommendations for streamlining the labyrinthine process for new officials (and the FBI has reportedly already been provided with around 100 names for "pre-approval"). The administration has already provided an unusual degree of access to the Treasury and other departments involved with stabilising the economy.

Mr Obama now has all the accoutrements of a president-in-waiting. He has a secret service entourage and secret service code-names ("renegade" for him and "renaissance" for his wife). He gets the same daily intelligence briefing as Mr Bush. But beneath the smooth surface there is still plenty that could go wrong.

For all the recent bonhomie there are lots of potential strains with the current occupant of the White House. Mr Obama is preparing to undo much of the Bush legacy, starting with Guantánamo Bay. The Bush White House—and particularly the vice-president's office—is notoriously secretive. Many economic decisions cannot wait until January. But Mr Obama does not see eye-to-eye with Mr Bush, to put it mildly. He is also wary of attempts by Hank Paulson, the treasury secretary, to turn him into a "co-owner" of the administration's economic policies, particularly on the Wall Street bail-out.

There are also plenty of potential fissures in Obamaworld. Mr Obama enthused an army of supporters by promising "change". But he has already co-opted several leading Clinton figures such as Mr Podesta. Some of the most prominent candidates for top jobs—Larry Summers for Treasury, John Kerry for State and Al Gore for the environment agency—are also ghosts from the past.

Then there is the problem that all transitions are bureaucratic nightmares. The new president appoints over 7,000 people, including more than a thousand who need to be confirmed by the Senate. Nominees endure an absurdly long nomination process, filling in 60 pages of forms and submitting themselves to extensive FBI vetting, during which plods from the bureau inquire about their taste for intoxicants and the legal status of their nannies. Mr Bush did not have his deputy cabinet officials in place until spring 2001, and sub-cabinet officials until the summer, when al-Qaeda was about to strike. The new president might have delivered "no drama with Obama" when he was running his own campaign. Now he must deal with Washington's gigantic and frequently doltish permanent establishment.

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Congress

Waiting for reinforcements

Nov 13th 2008 | WASHINGTON, DC
From The Economist print edition

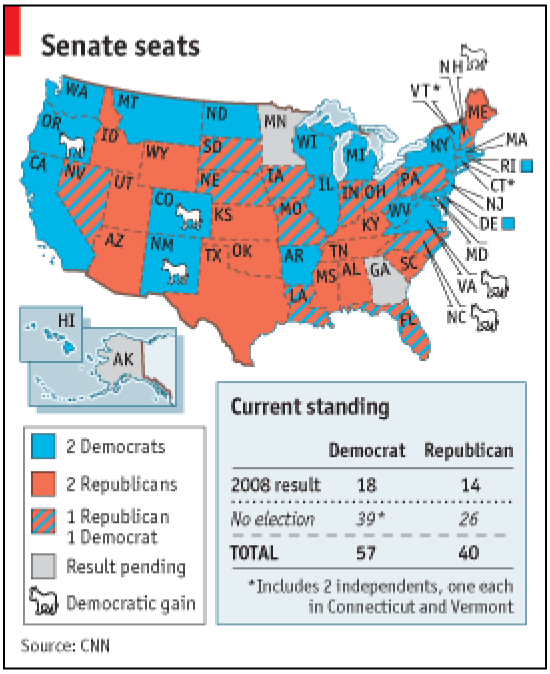
A turbulent few months are expected on Capitol Hill

AP

CHANGE is coming to Congress. The oldest senator, Robert Byrd of West Virginia (pictured), is to be shunted aside as chairman of the mighty appropriations committee. Mr Byrd, a Democrat, started winning elections 66 years ago, when his local chapter of the Ku Klux Klan picked him as its leader, or “Exalted Cyclops”. A senator since 1959, he is no longer a racist but is notorious for lavishing taxpayers’ cash on boondoggles named after himself. As he nears his 91st birthday, however, he is in poor health. He will be replaced by Senator Daniel Inouye of Hawaii, a sprightly 84-year old.

All this turmoil is occurring at a difficult time. The world economy is having a seizure. Carmakers in Detroit are begging for a bail-out. The Democrats who control Congress would like to help President-elect Barack Obama tackle these crises. But he will not become president until January 20th. For now, George Bush is the only man who can sign (or veto) laws. And only the old Congress can pass them: the new one does not take office till January 6th. A short-term economic stimulus is needed before then, and is likely to pass. Mr Bush also wants Congress to ratify a free-trade deal with Colombia. It probably won’t.

In the House of Representatives the Democrats have a comfortable majority, which will get even bigger next year. In the Senate they currently have only a 51-49 edge, including two independents, and next year’s line-up is still unclear. The Democrats will have at least 57 seats, a hefty majority. But three seats are still undecided. Recounts of close races in Alaska and Minnesota could drag on for weeks, with allegations of cheating from both sides. And a run-off will be held in Georgia on December 2nd, as local rules require, after neither candidate won more than 50% of the vote.



If the Democrats win all three seats, which is unlikely but not impossible, they will be able to shut down Republican filibusters and ram through any law they like. Republican big beasts, including John McCain,

are converging on Georgia to support Senator Saxby Chambliss in the run-off. A Democratic supermajority would mean: “No checks. No balances. No stopping them,” warns one website.

Meanwhile, Nancy Pelosi and Harry Reid, the top Democrats in the House and Senate, are furiously juggling. Even as their members jostle for jobs in the new Congress, they still have a lame-duck legislature to run. They seem to have kept a lid on the in-fighting, at least for now, but several big jobs are yet to be filled.

Since Joe Biden is moving to the White House, his plum spot as chairman of the Senate Foreign Relations Committee is up for grabs. John Kerry, a former Democratic presidential nominee, says he wants it. But if Mr Obama makes him secretary of state or ambassador to the UN, the more leftish Senator Russ Feingold of Wisconsin would be in line. Another question-mark hangs over Senator Joe Lieberman, the Democratic vice-presidential nominee in 2000. This year he backed John McCain for the presidency. Many Democrats want to punish him, by stripping him of his chairmanship of the homeland security committee or even kicking him out of the Democratic caucus. But Mr Obama is said to want to let bygones be bygones.

In the House some personnel changes portend a leftward shift. Rahm Emanuel, a forceful centrist, is leaving his Chicago seat to become Mr Obama’s chief of staff. His post as Democratic caucus chairman, the number-four job in the House, goes to John Larson of Connecticut, who is somewhat further to the left. And Henry Waxman of California is challenging John Dingell of Michigan for the chairmanship of the House committee that handles energy and climate change.

A bitter battle is brewing. Many ideological greens prefer Mr Waxman, who supports tougher curbs on carbon emissions and has a more belligerent approach to corporations. Many pragmatists prefer Mr Dingell, for the same reasons. A cap-and-trade bill will be much harder to pass now that the economy is in the doldrums, says a former Clinton White House staffer. Mr Dingell, who hails from Michigan, is trusted by the big carbon-emitting industries. Mr Waxman is not. So a deal next year may be more likely under Mr Dingell.

More immediately, congressional Democrats are urging Mr Bush to find as much as $50 billion to rescue the Big Three carmakers. Mr Dingell strongly supports this idea. So do most Democrats. If the government can bail out greedy bankers, they reason, surely it can help horny-handed workers keep their jobs. Plus, they see the cash infusion as an opportunity to insist on greener cars.

Many Republicans are aghast. If the financial system had collapsed, it would have devastated the entire economy. That is not true of carmakers. If the Treasury props them up, every badly-run company in America will beat a path to its door. But a bail-out looks likely. And if Republicans in the Senate lose their power to filibuster, the Democrats will abolish workers’ right to a secret ballot before unionising. That, warn Republicans, will let unions do to other firms what they did to General Motors.

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Government finances

Local zeroes

Nov 13th 2008 | CHICAGO, LOS ANGELES AND NEW YORK
From The Economist print edition

Cities and states are facing big budget deficits. It is partly their own fault

SOON after the election parties wound down, the gloomy pronouncements began. Arnold Schwarzenegger, California's governor, waited just two days after Barack Obama's victory before declaring that an $11.2 billion hole had appeared in this year's state budget. Michael Nutter, the mayor of Philadelphia, commandeered the airwaves to announce spending cuts and tell citizens to "prepare for the worst".

It is not the first time local governments have faced financial difficulties. States that relied heavily on income taxes suffered huge deficits following the stockmarket crash of 2001-02. Yet cities and counties, which mostly rely on property and sales taxes, often saw little or no drop in revenues. This time few are escaping. In many places all significant sources of public revenue—income taxes, business taxes, sales taxes and property taxes—are falling.

New York's Rockefeller Institute calculates that real tax revenues in the third quarter fell below 2007 levels in 31 out of 42 states that released figures. Worse is almost certainly to come. In the land of the $700 billion bail-out, expected shortfalls of a few billion dollars in the biggest states and cities might not seem catastrophic. Unlike the federal government, though, states are generally required to balance their books every year. And, unlike the bank rescue plan, there is no chance that the lost money will eventually come back.

The first places to run into trouble were those hit by the downturn in the housing market. Arizona, Florida and Nevada built too many unaffordable houses in the middle years of this decade. When mortgage rates reset, they suffered an epidemic of foreclosures. As prices plunged and buyers disappeared, revenues from sources as diverse as development fees and sales taxes on bathroom taps dropped.

These days the places in peril are those closely tied to Wall Street. Top of the list, naturally, is New York. Some 27% of direct tax revenues come from the securities industry, according to the Independent Budget Office. Job losses and lower bonuses mean the state is facing a $1.5 billion deficit this year and a $12.5 billion one next year. Connecticut, Delaware and New Jersey have also been caught in the down-draught.

One state has the great misfortune to belong to both troubled groups. California has suffered about a quarter of all foreclosures in America. Yet the state's fortunes are tied even more closely to the financial markets. More than half of all revenues to the general fund come from income taxes, and half of those taxes are paid by just 144,000 wealthy taxpayers. As stock options and capital gains disappear, California finds itself deeper in the red than any other state (see chart).

Like other states, California plans to put higher education and health on the chopping block (police budgets may be protected, thanks to the well-known link between rising unemployment and crime). Cities will neglect their parks and close swimming pools and libraries. Some plan to renegotiate union contracts and tell workers to stay at home for a few more days each year. Badly-behaved citizens will be fined a lot more. If Richard Daley gets his way, anybody who fails to stop at a red traffic light or returns a library book late in Chicago will be in for a shock. In New York state a reworked form of congestion-pricing may get another look.

Many are turning Keynesian. Gavin Newsom, the mayor of San Francisco, has pledged to use bond money to speedily begin work

on the city's main hospital. Jennifer Granholm, governor of the troubled state of Michigan and one of Mr Obama's economic advisers, wants to spur economic development by authorising the expansion of a convention centre and a light-rail network. Last week she wrote to Congress with a list of requests, including help with 70 infrastructure projects.

Congress may oblige with some cash for public works and health care in the new stimulus package that is now being debated. But big handouts are unlikely, at least before the next president takes office. The federal budget is already stretched. And the danger of moral hazard is even greater than when it comes to bailing out financial firms. Despite panicky, cliché-ridden talk of perfect storms and uncharted waters, many of the problems faced by local governments are of their own making.

Long before local governments had revenue problems, they had spending problems. They have guaranteed their employees lavish pensions and toughened criminal codes in such a way that prison populations have risen fast. Public spending in New York state has increased by more than 40% in the past five years; in California, general-fund expenditure has more than doubled since the mid-1990s.

Yet some local politicians seem determined to make matters worse. In July Illinois's governor, Rod Blagojevich, cut spending by $1.4 billion. That angered legislators, who moved to reverse some of his cuts. Mr Blagojevich must sign or veto their new bill by December 5th. Meanwhile revenue projections are worsening. On November 10th the state announced that income taxes, corporation taxes and sales taxes were falling below expectations.

It is for reasons of political expediency, as well as the suddenness of the collapse in revenues, that governors and mayors are moving so quickly now. There was little point trying to raise taxes or slash services just before the election—few candidates for public office would have supported such distasteful remedies. Now they might. And those who are about to leave office may prove even bolder. The hope in California is that politicians who have been forced out by term-limit laws can be prevailed upon to raise sales taxes from 5% to 6.5% and cut education spending.

So far there is little evidence that the ploy will work. California's Democrats, who enlarged their majority last week, seem cool to the idea of services cuts. The head of the Assembly's Republican caucus, which can block any changes to the budget, has been handing out a book warning of the dangers of increasing taxes. It is called "The End of Prosperity".

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Florida

Snowbirds, meet the repo men

Nov 13th 2008 | CAPE CORAL
From The Economist print edition

The property crash is devastating a boom town

YOU can gauge the depth of Florida's economic woes with a quick look at a parking lot on the north side of Cape Coral, on the state's south-western coast. Since the implosion of the local housing market last year, Gulf Coast Recovery has hauled in the cars of wiped-out building workers who fell behind on their payments. But now the beefy, heavily-tattooed repo men at Gulf Coast hoot about the red Corvette they have just towed away; and their lot contains Cadillacs, $40,000 Harley-Davidsons, even speedboats. “We don't mind taking those,” says Scott Friga, the company's owner. “They're toys.”

Cape Coral was a boom town a few years ago, buoyed by a huge upturn in house-building. Workers flooded in, and speculators and builders alike could buy Hummers on credit. In 2004 the Los Angeles-based Milken Institute rated the resulting sea of stucco and strip malls the best-performing city in America. Now it is 120th. One in 71 homes in Cape Coral's Lee County has a foreclosure filing, and nearly half the mortgages on recently purchased houses in the area are under water.

Now repo companies are the ones doing the booming. Gulf Coast Recovery's business is up about 80% from last year. Recently financiers have lengthened their grace periods, hoping that debtors will get their payments back on track. But the repo men anticipate a spike in calls once that time is up. Mike “Chevy” Gray can't wait. “I love angry people”, he says. He brandishes brass knuckles: “Very effective.”

As house prices have collapsed, the unemployment rate in Cape Coral and neighbouring Fort Myers has jumped from 5.7% a year ago to 9.2% in September, among the worst in the country. With no one hiring, Denise Stiles has been fired from her human-resources company. Unemployed, she sips her drink in a beer garden over the road from a boarded-up house with the word “bust” spray-painted on it. Her neighbours, she says, have stopped making their mortgage payments. When they get evicted they will go and live with relatives.

“I pray for a hurricane,” says Tom Lento, a former car customiser who has been working as a repo man for about six months, as he hunts for a white pickup truck belonging to a woman whose business has failed. If a bad storm struck, Mr Lento explains, he could collect an insurance cheque and leave the city. He finds the truck in a drugstore car park, hooks it and drives off in less than a minute. The only better business in town these days, he says, is cleaning up crime scenes.

This is the time of year that “snowbirds”—Americans from colder climes—migrate to Florida to escape their northern winters. But with their retirement accounts shrivelled, and cleaning up crime scenes apparently a growth industry, some may not make the trip. Even if many still do, they were already spending less by last summer, with the exception of alcohol (up 41%) and gambling (up 352%).

There are glimmers of hope. Honey Isham, a local property agent, says her business is inching up again as bargain-hunters look for cheap property. But the boom is over. Housing starts, which were still soaring as recently as 2005, are now at a 20-year low. Mike Quaintance, the president of Cape Coral's chamber of commerce, predicts it will be another 18 months before enough of the city's stock of houses is sold for prices to rise much. In the meantime, Cape Coral's fate will depend on how many snowbirds migrate south for the winter, and how much they spend when they get there.

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Chicago

The spotlight beckons

Nov 13th 2008 | CHICAGO
From The Economist print edition

Barack Obama's ascendancy portends America's third city's, too

TELEVISION sets across the world showed a vast sea of people, young and old, black and white, dancing and crying and cheering. In the background stretched a twinkling skyline with "Vote 2008" and "USA" spelled out in lights. Almost a week later Richard Daley, Chicago's mayor, could still barely contain himself. It "was like a baptism, a confirmation, a bar mitzvah", he exclaimed (neatly covering his ethnic bases). He was talking about Barack Obama's election. But it was Chicago's night, too.

This "city of big shoulders", in the poet Carl Sandburg's phrase, has long had a chip on one of them, sulking over the attention paid to New York and Los Angeles. Tales of Al Capone, hog-butchers and machine-style politics have been hard to dispel. Forty years ago Grant Park was the site of Richard J. Daley's shame, as police clashed with protesters at the Democratic National Convention. But on November 4th Grant Park was a source of pride for his son, the younger Mr Daley. The city, still buzzing from the election, is now wondering what comes next.

Chicago is in many ways ready for the spotlight. The city is a hub for corporate headquarters, with new residents including Boeing and, soon, MillerCoors. Mr Daley is a mostly benevolent dictator. Under his watch the city has cleaned up and built up, with a shiny new jewel, Millennium Park, complementing older architectural treasures. Still, uglier aspects remain. The transport system is decrepit. The city's murder rate is twice that of New York, and significantly worse than Los Angeles's too. Patrick Fitzgerald, the federal prosecutor for northern Illinois, has begun to shed light on state corruption. His findings have not been pretty.

Talk of how an Obama presidency might affect Chicago range from the petty (will motorcades mean more traffic?) to the presumptuous (when will the gravy train roll in?). One reasonable bet is that Mr Obama will pay attention to urban issues. He will, unusually, be a big-city president, and has a raft of proposals to help metropolitan areas. "He has a real understanding of the urban problems confronting America," Mr Daley argues. What is good for Chicago will be good for other cities too.

But there are more selfish hopes as well. Among the most basic is that Chicago will receive the attention it has craved, both from the coasts and from abroad. Already, Mr Daley says, national reporters are visiting local restaurants, museums and hotels and should become "a little more educated" about Chicago. Local civic leaders have an obsession with being a "global city"—the Chicago Council on Global Affairs has a branch specifically devoted to that. Rachel Bronson of the Chicago Council, travelling in Dubai after the election, says she has met a new surge of interest in her city. "Many will start discovering it," she says hopefully.

Indeed, Chicago's tourism bureau has wasted no time in using Mr Obama as a lure for tourists. Early on November 5th the bureau released a "Presidential Chicago" tour of the Obamas' favourite haunts. One of them, a subterranean bookstore near the University of Chicago, calls attention to itself with a sign congratulating "our longtime customer". Down the street, Medici Bakery has kitted out its employees in "Obama eats here" T-shirts.

The biggest coup would be if Mr Obama helps Chicago win the Olympic games in 2016, which would give the city a star turn on the world stage. Mr Daley says Mr Obama could play a leading role, and points to Tony Blair's help in winning the 2012 games for London. It might work.

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School reform

A worthy experiment

Nov 13th 2008 | SAN ANTONIO
From The Economist print edition

Vouchers versus the status quo in Texas

Illustration by Claudio Munoz

THE Edgewood independent school district covers an unassuming part of west San Antonio, a district of fast-food joints and car-body shops, with houses that run from modest to ramshackle. It is mostly poor and mostly Hispanic, and in 1968 its government-funded public schools were so bad that a parents' group sued the state, prompting a debate over school funding that lasted for decades. By 1998 the situation had improved. The National Education Association, America's largest teachers' union, said that Edgewood could be a model for other urban school districts.

Then its voucher programme started. In 1998 the Children's Educational Opportunity Foundation, a private group, announced that it would put up $50m over the next ten years to provide vouchers for private education to any low-income Edgewood student who wanted one. The "Horizon" plan was meant to show legislators that vouchers could help students and motivate schools through competition.

Critics said the programme would take money from a school district that was poor already. One teacher wrote an angry editorial comparing Horizon to Napoleon's invasion of Russia, destined for "history's trash heap of bad ideas".

But a report published in September by the Texas Public Policy Foundation (TPPF), a conservative think-tank, argues that the programme was a hit over its ten-year span. More than 4,000 students claimed the vouchers; their test scores jumped, and only two dropped out.

And Edgewood's public schools were not crippled. During Horizon's busiest year only 12.8% of students took vouchers. The dropout rate decreased, teachers' salaries increased and by 2008 the district had graduated from "acceptable" to "recognised", according to the state's education agency. Brooke Dollens Terry of TPPF says that the Edgewood results should embolden future reformers: "I think we've proven that the walls of the school didn't come crumbling in."

But the causes of Edgewood's improvement are up for debate. The TPPF chalks it up to competition. Liz Garza, the district superintendent, thinks it reflects efforts to meet state standards, which were getting tougher over the same period. Paul Kelleher, who chairs the education department at Trinity University, says the TPPF report is inconclusive. He thinks that although vouchers may help some students, a full-scale programme would backfire as resources moved away from inner-city schools.

The issue may be moot. The idea behind Horizon was that a successful private experiment would spur lawmakers to try a public version. But the legislature has declined to do so, and teachers' groups are ready to pounce on any pro-voucher manoeuvres.

So attention is moving to other reforms, such as independent "charter" schools. These keep students in the public system while offering parents a choice and school heads freedom from bureaucracy. But there are only 209 charter schools in all of Texas, and the legislature has capped their number at 215. The last charter will probably be issued soon, says Ms Terry, and there are still at least 16,000 students on waiting lists.

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Economist.com
WORLD
UNITED STATES

Lexington

Ship of fools

Nov 13th 2008
From The Economist print edition

Political parties die from the head down

Illustration by KAL

JOHN STUART MILL once dismissed the British Conservative Party as the stupid party. Today the Conservative Party is run by Oxford-educated high-fliers who have been busy reinventing conservatism for a new era. As Lexington sees it, the title of the “stupid party” now belongs to the Tories’ transatlantic cousins, the Republicans.

There are any number of reasons for the Republican Party’s defeat on November 4th. But high on the list is the fact that the party lost the battle for brains. Barack Obama won college graduates by two points, a group that George Bush won by six points four years ago. He won voters with postgraduate degrees by 18 points. And he won voters with a household income of more than $200,000—many of whom will get thumped by his tax increases—by six points. John McCain did best among uneducated voters in Appalachia and the South.

The Republicans lost the battle of ideas even more comprehensively than they lost the battle for educated votes, marching into the election armed with nothing more than slogans. Energy? Just drill, baby, drill. Global warming? Crack a joke about Ozone Al. Immigration? Send the bums home. Torture and Guantánamo? Wear a T-shirt saying you would rather be water-boarding. Ha ha. During the primary debates, three out of ten Republican candidates admitted that they did not believe in evolution.

The Republican Party’s divorce from the intelligentsia has been a while in the making. The born-again Mr Bush preferred listening to his “heart” rather than his “head”. He also filled the government with incompetent toadies like Michael “heck-of-a-job” Brown, who bungled the response to Hurricane Katrina. Mr McCain, once the chattering classes’ favourite Republican, refused to grapple with the intricacies of the financial meltdown, preferring instead to look for cartoonish villains. And in a desperate attempt to serve boob bait to Bubba, he appointed Sarah Palin to his ticket, a woman who took five years to get a degree in journalism, and who was apparently unaware of some of the most rudimentary facts about international politics.

Republicanism’s anti-intellectual turn is devastating for its future. The party’s electoral success from 1980 onwards was driven by its ability to link brains with brawn. The conservative intelligentsia not only helped to craft a message that resonated with working-class Democrats, a message that emphasised

entrepreneurialism, law and order, and American pride. It also provided the party with a sweeping policy agenda. The party's loss of brains leaves it rudderless, without a compelling agenda.

This is happening at a time when the American population is becoming more educated. More than a quarter of Americans now have university degrees. Twenty per cent of households earn more than $100,000 a year, up from 16% in 1996. Mark Penn, a Democratic pollster, notes that 69% call themselves "professionals". McKinsey, a management consultancy, argues that the number of jobs requiring "tacit" intellectual skills has increased three times as fast as employment in general. The Republican Party's current "redneck strategy" will leave it appealing to a shrinking and backward-looking portion of the electorate.

Why is this happening? One reason is that conservative brawn has lost patience with brains of all kinds, conservative or liberal. Many conservatives—particularly lower-income ones—are consumed with elemental fury about everything from immigration to liberal do-gooders. They take their opinions from talk-radio hosts such as Rush Limbaugh and the deeply unsubtle Sean Hannity. And they regard Mrs Palin's apparent ignorance not as a problem but as a badge of honour.

Another reason is the degeneracy of the conservative intelligentsia itself, a modern-day version of the 1970s liberals it arose to do battle with: trapped in an ideological cocoon, defined by its outer fringes, ruled by dynasties and incapable of adjusting to a changed world. The movement has little to say about today's pressing problems, such as global warming and the debacle in Iraq, and expends too much of its energy on xenophobia, homophobia and opposing stem-cell research.

Conservative intellectuals are also engaged in their own version of what Julian Benda dubbed *la trahison des clercs*, the treason of the learned. They have fallen into constructing cartoon images of "real Americans", with their "volkish" wisdom and charming habit of dropping their "g"s. Mrs Palin was invented as a national political force by Beltway journalists from the *Weekly Standard* and the *National Review* who met her when they were on luxury cruises around Alaska, and then noisily championed her cause.

Time for reflection

How likely is it that the Republican Party will come to its senses? There are glimmers of hope. Business conservatives worry that the party has lost the business vote. Moderates complain that the Republicans are becoming the party of "white-trash pride". Anonymous McCain aides complain that Mrs Palin was a campaign-destroying "whack job". One of the most encouraging signs is the support for giving the chairmanship of the Republican Party to John Sununu, a sensible and clever man who has the added advantage of coming from the north-east (he lost his New Hampshire Senate seat on November 4th).

But the odds in favour of an imminent renaissance look long. Many conservatives continue to think they lost because they were not conservative or populist enough—Mr McCain, after all, was an amnesty-loving green who refused to make an issue out of Mr Obama's associations with Jeremiah Wright. Richard Weaver, one of the founders of modern conservatism, once wrote a book entitled "Ideas have Consequences"; unfortunately, too many Republicans are still refusing to acknowledge that idiocy has consequences, too.

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Nicaragua

How to steal an election

Nov 13th 2008 | MANAGUA
From The Economist print edition

Daniel Ortega sets an ugly precedent

AP

NICARAGUA may be a small country but it is an emblematic one. In 1979 the leftist Sandinista movement overthrew a corrupt dictatorship. In response, the United States organised the Contra guerrillas. In 1990 the Sandinistas agreed to hold free elections, which they lost. But their leader, Daniel Ortega, has returned to power, having won a presidential election in 2006 against a divided opposition. Now, armed with an alliance with Venezuela's Hugo Chávez, he seems determined to snuff out Nicaragua's young democracy.

In the months before municipal elections on November 9th, Mr Ortega's government manoeuvred to disqualify two opposition parties from the ballot. It sent police to ransack the offices of the country's leading investigative journalist, Carlos Fernando Chamorro, and those of a women's group. It is investigating another 15 organisations, including Oxfam, a British aid agency, for money-laundering and "subversion". Many former Sandinista leaders have split with Mr Ortega, whose approval rating in opinion polls has slumped towards 20%.

For the first time since 1990, independent observers, foreign and local, were refused accreditation to monitor the election. Mr Ortega said that they were barred because they were backed by "outside powers". To underline the fact that the Supreme Electoral Council, the supposedly independent electoral authority, is under the government's thumb, its head accompanied Mr Ortega when he voted.

According to the electoral council's provisional results, the Sandinistas duly won 94 of the 146 mayorships at stake. By far the most important is Managua, the capital and home to a third of the population of less than 6m. It has been governed by the Sandinistas for the past eight years. But in the run-up to the vote Eduardo Montealegre, of the centre-right Constitutionalist Liberal Party (PLC), was ahead of the Sandinista candidate, Alexis Argüello, a former world-champion boxer. The official count in Managua was suspiciously slow, but with 70% of the votes tallied the electoral council claimed that Mr Argüello had won 51.3% and Mr Montealegre 46.5%.

Mr Montealegre, a former banker with an MBA from Harvard University, was the runner-up to Mr Ortega in the 2006 presidential election, which was watched by observers from the Organisation of American States (OAS), the European Union and the Carter Center. On that occasion Mr Montealegre swiftly conceded defeat.

This time he says that he won the election, and that the PLC is being robbed of victory by fraud both in Managua and in León, the second city. His aides say that the electoral council handed out voter identity cards to those likely to support the Sandinistas while withholding them from opposition supporters. It also withheld credentials from opposition representatives to try to stop them witnessing the count. On election day, many of them were barred from polling stations, some of which closed early. Nevertheless the opposition managed to get hold of copies of the official tally at many polling stations, and it is from these lists that Mr Montealegre has compiled figures showing that he won.

Ethics and Transparency, an independent Nicaraguan group, organised tens of thousands of observers. Refused accreditation, they had to watch from outside polling stations. But the group estimates that irregularities occurred at a third of polling places. Their complaints were echoed by Nicaragua's Catholic bishops. "People feel defrauded," said Leopoldo Brenes, Managua's archbishop. The OAS expressed "concern" while the United States' government cast doubt on whether the election was free and fair. Opposition supporters clashed with Sandinistas, each side throwing stones at the other.

Mr Montealegre wants a recount supervised by international observers. The council offered a locally supervised review. Mr Ortega may try to ride out the protests. But European governments are increasingly fed up with the president's authoritarianism, and are preparing to cut their economic aid (which accounts for a third of the government's budget).

Unless there is a proper recount, an ugly precedent for Latin America will have been set. Electoral fraud is largely a thing of the past in the region, and democracy has become a habit (see article). A bigger test of commitment to the rules will come in state and local elections in Venezuela later this month. Mr Chávez, Venezuela's socialist president, has manoeuvred to disqualify the most popular opposition candidate for mayor of Caracas. He has threatened other opposition candidates with spurious corruption probes. Despite what they claim is a crisis of capitalism, it seems that some of Latin America's radical leftists fear the verdict of the people.

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The Latinobarómetro poll

Democracy and the downturn

Nov 13th 2008
From The Economist print edition

Latin Americans are standing up for their rights

FIVE years of strong economic growth have prompted a slow but fairly steady rise in support for democracy and its institutions among Latin Americans, although many remain frustrated by the way their political systems work in practice. Most see themselves as politically moderate, but they retain a yearning for strong leaders and expect the state to solve their problems. These are some of the findings from the latest Latinobarómetro poll taken in 18 countries across the region and published exclusively by *The Economist*. Because the poll has been taken regularly since 1995, it tracks changes in attitudes in the region.

A reviving faith in the ballot box 1

Which of the following statements do you agree with most? %

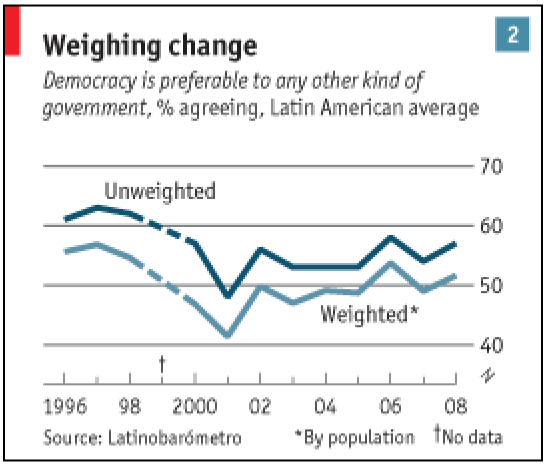
	Democracy is preferable to any other type of government					In certain circumstances an authoritarian government can be preferable to a democratic one				
	1996	2001	2007	2008	*Change since 2007*	1996	2001	2007	2008	*Change since 2007*
Paraguay	59	35	33	53	*20*	26	43	36	29	*-7*
Venezuela	62	57	67	82	*15*	19	20	14	9	*-5*
Colombia	60	36	47	62	*15*	20	16	12	8	*-4*
El Salvador	56	25	38	50	*12*	12	10	20	27	*7*
Dominican Rep.	na	na	64	73	*9*	na	na	21	15	*-6*
Honduras	42	57	38	44	*6*	14	8	17	15	*-2*
Chile	54	45	46	51	*5*	19	19	21	14	*-7*
Uruguay	80	79	75	79	*4*	9	10	10	6	*-4*
Brazil	50	30	43	47	*4*	24	18	17	19	*2*
Guatemala	50	33	32	34	*2*	21	21	33	27	*-6*
Bolivia	64	54	67	68	*1*	17	17	14	10	*-4*
Peru	63	62	47	45	*-2*	13	12	22	20	*-2*
Argentina	71	58	63	60	*-3*	15	21	20	19	*-1*
Nicaragua	59	43	61	58	*-3*	14	22	10	8	*-2*
Mexico	53	46	48	43	*-5*	23	35	14	15	*1*
Panama	75	34	62	56	*-6*	10	23	13	15	*2*
Ecuador	52	40	65	56	*-9*	18	24	13	16	*3*
Costa Rica	80	71	83	67	*-16*	7	8	5	14	*9*

Source: Latinobarómetro

This year's poll was taken in September and early October. It therefore reflects the sharp increase in inflation in the region in the first half of this year, but not the full effect of the financial turbulence and deteriorating economic outlook that hit some Latin American countries in recent weeks. Nevertheless, it carries some sobering lessons for the region's politicians.

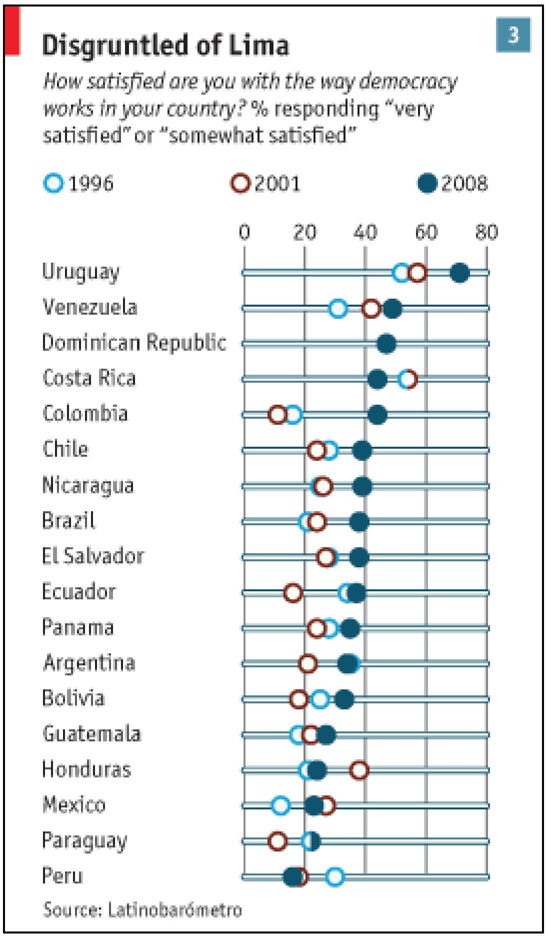
The poll underlines the fact that a small majority of respondents are convinced democrats (see table 1 and chart 2). In 12 countries, support for democracy has risen since 2001, when the region last suffered an economic recession. But only in five countries is it higher than it was in 1996. This year democracy has received a particular boost in Paraguay, a country where authoritarian attitudes previously predominated. The shift follows the victory in a presidential election in April of

Fernando Lugo, a leftish former bishop who ended more than half a century of rule by the Colorado Party. That echoes similar hopes of change aroused by newly elected leaders in the region in recent years.



Conversely, in Venezuela, support for democracy may have been boosted this year among opponents of President Hugo Chávez, after their victory in a referendum on constitutional change last December. In Colombia, President Álvaro Uribe's success against the FARC guerrillas may be the reason for a similar democratic lift.

Uruguayans are by far the most satisfied with how their democracy works (see chart 3). Peruvians are particularly disgruntled. That is paradoxical: Peru's economy has grown faster than that of any other of the region's bigger countries both this year and last. Their discontent seems to reflect deep flaws in the political system. But even if slightly less than two-fifths of respondents across the region are satisfied with their democracies, that is a significant improvement on the 2001 figure.

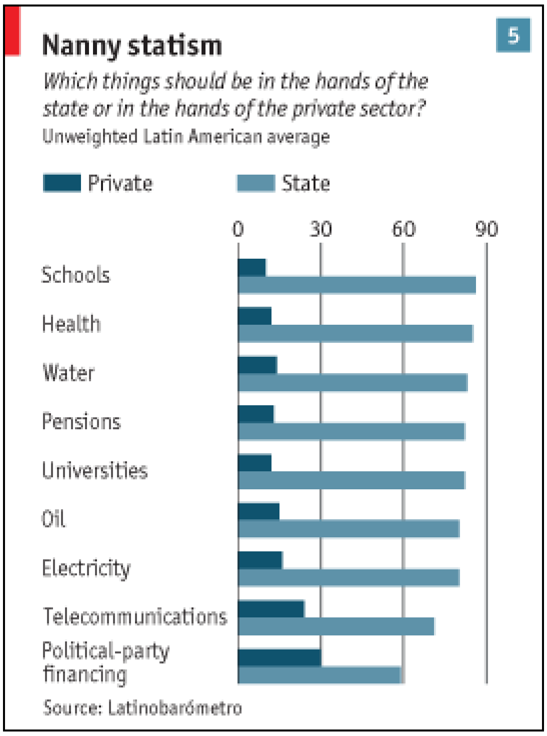


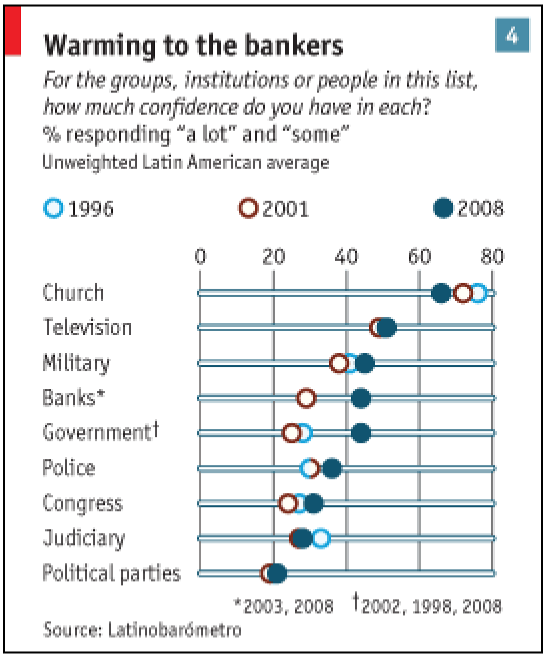
The relative dissatisfaction owes much to the deep-rooted socioeconomic inequalities in Latin America. Across the region 70% of respondents agreed that governments favour the interests of the privileged few; around half say they would not mind a non-democratic government if it solved economic problems; a similar proportion say democracy has not reduced inequalities; and only 30% think there is equality before the law. These attitudes help to explain the popularity of Mr Chávez, an oil-rich strongman—more than a third of Venezuelan respondents say inequalities have diminished.

But most respondents are convinced that democracy is the only road to development—and 71% say they are personally happy. So why the grumbles? As democracy has come to stay in the region, "people are more conscious of their rights and their expectations are higher", says Marta Lagos, Latinobarómetro's director. She adds that the yearning for a strongman is more a cultural trait than a political preference—and that the same goes for a fondness for a paternalist state.

The poll shows that a large majority believe that pensions should be in state hands (see chart 5). In Argentina that number is 90%, which perhaps helps

explain why President Cristina Fernández last month nationalised the private pension system. But at the same time 56% of respondents see a market economy as the road to development (up from 47% last year). And 32% declare themselves satisfied with privatised public services, up from 15% in 2004. Some 44% say they trust their banks, up from 29% in 2003. The church remains the most trusted institution in the region—but less so than it was. Trust in government and legislatures continues to edge up (see chart 4).





In six countries, including Mexico and Venezuela, crime and public safety are seen as the most important problem. In ten countries, economic concerns (unemployment, poverty and inflation) are still seen as paramount. In Brazil 19% cited health care as the biggest problem.

Despite the swing to the left in the region in recent years, most respondents to the poll consider themselves in the political centre (42% this year, up from 29% in 2003). Only 17% say they are on the left and 22% are on the right (even in Mr Chávez's Venezuela those on the left and right are tied at 26%).

That provides hope for centre-right politicians in a round of presidential elections in the larger countries in the region in 2010-12. Those elections are likely to be held against a much less rosy economic backdrop than has prevailed for the past few years. The task facing Latin America's politicians is to ensure that economic difficulties do not spill over into a weakening of support for democracy.

Latinobarómetro is a non-profit organisation based in Santiago, Chile, which has carried out regular surveys of opinions, attitudes and values in Latin America since 1995. The poll was taken by local opinion-research companies in 18 countries and involved 20,217 face-to-face interviews conducted between September 1st and October 11th 2008. The average margin of error is 3%. Further details from www.latinobarometro.org

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Canada's economy

Breaking the deficit taboo

Nov 13th 2008 | OTTAWA
From The Economist print edition

The provinces plead for cash

KEEPING the budget in surplus has been a near-obsession in Canada ever since a Liberal government felt obliged to slash public spending in the mid-1990s to end almost three decades of deficits and rising public debt. In the campaign for last month's general elections, all five party leaders vowed to maintain a budget surplus. Yet within days of winning a second term at the head of a minority government, Stephen Harper, the Conservative prime minister, admitted that "global economic instability" meant that next year's budget might involve a deficit.

That makes sense: governments across the world are resorting to deficit spending as their economies slide into recession. For much of this year, Canada seemed aloof from financial turmoil, but its exports are feeling the effects of plunging commodity prices and falling demand in the United States, its main trading partner.

Yet breaking the taboo against deficits still involves a political risk. Mr Harper must persuade Canadians that the government is only temporarily going into the red, and not because of its own mistakes, says Darrell Bricker of Ipsos-Reid, a polling firm. Paul Martin, a former Liberal prime minister who as finance minister eliminated the deficit, is one of many opposition figures who insist that Canada could stay in surplus if the Conservatives had not mismanaged the public finances.

After taking office in February 2006 the Conservatives broke their own promise to keep spending increases broadly in line with economic growth. They also ended a Liberal tradition of keeping at least C$3 billion ($2.4 billion) in reserve to cover contingencies. Only a windfall of C$4.3 billion from an auction of wireless spectrum in July will prevent a deficit in the current fiscal year ending in March.

Still, there is no shortage of supplicants for public money. The queue is headed by the provincial premiers, most of whom met Mr Harper this week. Jean Charest of Quebec, who is seeking a third term at an election next month, turned up with a detailed list: a high-speed train link between Quebec City and south-western Ontario (costing at least C$23 billion); federal aid for manufacturing and forestry; and the transfer to the province of C$4 billion of federal money for infrastructure.

Ontario's Dalton McGuinty wants a federal bail-out for his province's car industry like the one being mounted across the border. Unless Canada matches America's largesse, Ontario plants will close, he says. He is emboldened by Ontario, long the richest province, having recently been designated as eligible for top-up federal funding under the complicated formula to ensure parity of public spending per head.

With the economy forecast barely to grow next year, and oil royalties and petrol taxes raising less money, tax revenues are set to fall quite sharply. Nevertheless, Mr Harper told the premiers that he is willing to consider higher spending, especially on infrastructure. He will reveal his budget plans before Christmas and meet the premiers again in January. He is quietly cutting other spending commitments: he has axed plans for a national portrait gallery announced by a previous Liberal government. That is unpopular. But voters are likely to support Mr Harper if he takes decisive action to mitigate recession, even at the cost of a deficit.

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Economist.com WORLD ASIA

Australia and the credit crunch

Digging for victory

Nov 13th 2008 | CLOUD BREAK, WESTERN AUSTRALIA
From The Economist print edition

China's appetite for its minerals offers Australia some shelter from the storm

Reuters

TWO straight railway lines run through the red desert of the Pilbara region, in Western Australia, almost touching each other in places. One belongs to BHP Billiton, a big mining company, hauling iron ore in trains more than a mile long to ships bound for China and elsewhere in Asia. The other lugs ore for Fortescue Metals, a relative newcomer. China's demand for the Pilbara's minerals to feed its insatiable steel mills has been a bedrock of Australia's boom for much of this decade. With the onset of the global financial crisis, the region is now proving crucial to whether Australia can defy the fate of other rich countries and avoid a recession.

At first the portents looked good. Australia prospered through the Asian financial crisis 11 years ago. Once derided as an "old economy" dependent on commodities, Australia's tangible assets in fact underwrote a further stroke of luck as China's rapid growth created an unprecedented market for iron ore and coal. China is now Australia's biggest trading partner; it buys 40% of the Pilbara's iron ore.

A few months ago, this seemed enough to protect Australia from the storms buffeting the world economy. No longer. On November 5th the federal Treasury shaved Australia's 2008-09 growth forecast from 2.75% in May's budget to 2%. It also cut by three-quarters the forecast budget surplus of almost A$22 billion ($15 billion). Some of this was the result of a A$10.4 billion stimulus package that Kevin Rudd, the prime minister, announced last month. But the Treasury also cited falling revenues linked to the global financial crisis, and a weaker outlook for growth and demand among Australia's emerging-economy customers, including China.

Five days later the central bank delivered a bleaker prognosis. It forecast annual growth falling to just 1.5%. Some economists believe even this is optimistic. Only two months ago Glenn Stevens, the bank's governor, lauded as "the largest shock of its kind" an improvement of almost two-thirds in Australia's terms of trade over five years. The growth has been driven largely by demand from China, and especially by record rises the mining companies negotiated earlier this year in contract prices for iron ore and coal. Now, the bank declared, the terms of trade had peaked.

The same day as the central bank's report, Fortescue and Rio Tinto, another mining company, announced

they were cutting their Pilbara iron-ore production by 10% because of China's slowing industrial output. Just as they did so, China announced a $586 billion spending plan to recharge its economy (see article). Mr Rudd described it as "extraordinary" and "very good news" for Australia's economy, too. In early October, as the full impact of the financial crisis sunk in, Mr Rudd, having sought reassurance from Wen Jiabao, his Chinese counterpart, that China's demand for Australia's commodities would stay strong, declared China "critical" for Australia's economic performance. So China's stimulus this week, inspiring visions of more iron ore needed for steel to build housing and infrastructure, has brought fresh hopes that the Pilbara once again will be the lucky country's saviour.

A region slightly smaller than Spain, about 1,300km (675 miles) north of Perth, the Pilbara was first mined for iron ore in the 1960s when Japan was East Asia's emerging industrial giant. Until recently, its reserves were pretty much carved up by a comfortable duopoly of Rio Tinto and BHP, two global giants. The China-based boom has been enlivened by the arrival of a third competitor in the form of Fortescue Metals, a Perth-based company started by Andrew Forrest, a former stockbroker.

Mr Forrest's challenge to the big boys' market control, and his colourful background, have made him something of a media darling. His great-great uncle was a pioneer, explorer and Western Australia's first premier. Mr Forrest's first bid as a commodities entrepreneur, through a nickel-mining venture, ended in tears seven years ago when his then company failed to meet promised production targets.

Undeterred, he spotted a chance to make a fortune from iron ore. He noticed that, just as China's boom started gathering steam earlier this decade, Australia's share of the market was falling, and those of India and Brazil were rising. Defying market sceptics, he raised almost A$3 billion, mainly from American bondholders, to launch Fortescue. In May, barely five years after he founded the company, it shipped its first iron ore to Baosteel, China's biggest steel company.

At that time, few people outside the business world, and his home state, had heard of Mr Forrest. Yet in the same month, *Business Review Weekly*, a Sydney magazine, declared him Australia's richest person, with wealth of almost A$10 billion, mainly in Fortescue shares. Six months later, he has lost the status. In a sign of the mining boom's rollercoaster ride, Fortescue's share price, like those of other commodities companies, has fallen steeply since the financial crisis hit.

Mr Forrest maintains the wealth ranking means little to him. "I want to enjoy life, have fun and be useful," he says in his Perth office, a relatively modest affair compared with the towers his two global competitors occupy up the street. Fun or not, they have been forced to take Mr Forrest seriously. Cloud Break, Fortescue's only operating mine, lies in isolated desert, near the dry Fortescue River, about 270km south-east of Port Hedland (see map). When BHP refused Mr Forrest's request for commercial access to its railway line, he built his own line next to it. Wayne Swan, Australia's treasurer, ruled last month that both BHP and Rio Tinto must allow Fortescue access to their Pilbara railway lines to boost mining competition. The two big companies have indicated they may appeal against the ruling.

In what he calls "the most important part of anything I've ever stood for", Mr Forrest has also persuaded Mr Rudd to back a scheme he initiated to create 50,000 jobs for indigenous Australians within two years across all industries, not just mining. The issue is especially sensitive in the ore-rich Pilbara, where

aborigines comprise 20% of the population (compared with 2% Australia-wide). Mr Forrest grew up there, and saw to his dismay children "equal to me in the classroom and on the sports field" end up on welfare, while he and other whites forged ahead.

The job-creation plan now seems ambitious. The Treasury predicts the global slowdown will lift national unemployment to 5% next year, and to almost 6% in 2010. Rio Tinto, the Pilbara's biggest operator, has 11 mines including Tom Price, the oldest and still one of the richest in ore quality. Just before the crisis, Sam Walsh, Rio's iron-ore chief in Perth, declared it had invested all its Pilbara earnings from the past five years, around A$9 billion, into expanding its export capacity by 60%. This week, by contrast, Rio cut annual-production targets by 20m tonnes.

Despite the slump, the miners are staying outwardly optimistic. Tom Albanese, Rio's chief executive, says gamely that China's slowdown will be short and sharp. He expects "rebounding" demand in 2009. BHP, in the throes of a takeover bid for Rio, has announced no production cuts so far. Fortescue, possibly the most vulnerable of the three because of its sole reliance on iron ore, has delayed next year's planned production target until 2010. Graeme Rowley, Fortescue's executive director, argues nevertheless that China's need for iron ore and steel to continue its "revolution" of building new cities means that "Australia will remain constructively and very positively part of China's future". The pace at which that happens will decide not just Australia's capacity to avoid the worst of the global downturn. It may also determine the outcome of a David-and-Goliath battle of raw capitalism in the Pilbara.

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New Zealand's election

Key change for Kiwis

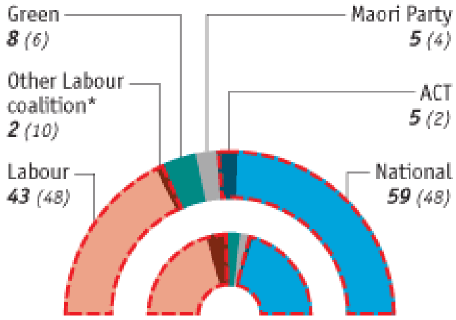
Nov 13th 2008 | AUCKLAND
From The Economist print edition

A long time coming in New Zealand, too

NOT quite Obama v McCain. But New Zealand's general election on November 8th also ushered in political change. Voters resoundingly rejected the Labour-led centre-left coalition led by Helen Clark, prime minister since 1999, and turned to the centre-right National Party. Under New Zealand's mixed member-proportional system, National won 59 of 122 parliamentary seats, but it can also count on the six seats of two small right-wing parties.

John Key, the new prime minister, is Barack Obama's age, 47, and relatively new to politics. A millionaire former investment banker of humble origins, his amiable personality went down well in a lacklustre campaign. Yet up to the end, Miss Clark, who has since stepped down as Labour leader, enjoyed high personal ratings and international praise. Labour has presided over huge reductions in government debt and unemployment, steady GDP growth, the creation of savings schemes and bilateral trade deals. Earlier this year, New Zealand became the first developed country to sign a free-trade agreement with China.

The Key to success
New Zealand parliament, seats **2008** *(pre-election)*



Source: New Zealand government and parliament
*New Zealand First, United Future, Progressive

But since the previous election in 2005, it has governed with the support of the populist New Zealand First party. When its leader was implicated in a party-finance scandal this year, Labour was tainted by association. Clumsy legislation to make political-party funding more transparent appeared cynically self-serving. A law banning parents from hitting their children caused bitter division. Labour's campaign theme of "trust" looked tired. Its attempt to link Mr Key with a 20-year-old shady foreign-exchange deal at a firm where he once worked looked desperate, and failed.

Under Mr Key since 2006, National has presented itself as more business-friendly and less bureaucratic than Labour, promising to cut taxes and to stem the tide of emigration to Australia. But, as the Reserve Bank, the central bank, predicted on November 12th, a tough year lies ahead. New Zealand has slipped into recession, unemployment is rising and house prices are falling. A small, isolated country, it has one of the world's most unregulated economies and is highly dependent on foreign investment, the export of agricultural commodities and long-haul tourism. So it is very vulnerable to the slowdown in the global economy.

National has given few clues about how it will deal with this. It has mentioned investing in infrastructure, notably roads, using public-private partnerships. Bryan Gould, once a member of Britain's Parliament, now a political commentator, reckons it will play safe at first, continuing Labour's caution in economic management.

However, it may come under pressure from its ally, the Association of Consumers and Taxpayers (ACT), whose MPs include Sir Roger Douglas, architect of the free-market "Rogernomics" of the 1980s. The ACT wants state-asset sales, tax cuts and the scrapping of Labour's carbon-emissions trading scheme. Perhaps to insure against the ACT's demands, National was this week also discussing a deal with the Maori Party. Mr Key seems a determined centrist. But both potential coalition partners and global economic forces may demand some extreme measures.

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Indonesia after the Bali bombers

Secular trends

Nov 13th 2008 | BANGKOK
From The Economist print edition

The struggle to set limits on militancy

WITHIN weeks of the bombings that killed 202 people, mostly tourists, in Bali in 2002, three of the main perpetrators were caught. In 2003 death sentences were handed to Amrozi bin Nurhasyim—dubbed “the smiling bomber” for the remorseless grin he wore during his trial—his brother, Mukhlas, and Imam Samudra. The bombers, members of Jemaah Islamiah (JI), a South-East Asian affiliate of al-Qaeda, bragged of relishing martyrdom. But they appealed against their sentences repeatedly, most recently arguing that a firing squad was “inhumane” and asking to be beheaded. Indonesia’s authorities, fearing an Islamist backlash and further bombings, repeatedly put off the executions. Eventually, on November 9th, the three were shot at a prison island off Java.

Reuters

A bomber of many; a martyr to some

Thousands of militants turned out for the bombers’ funerals but they passed off largely peacefully. Days before the executions anonymous death threats were made against President Susilo Bambang Yudhoyono. The security forces went on high alert. But, so far at least, the country has remained calm. Its two mainstream Muslim movements and a clerics’ body, the Indonesian Ulemas Council, all condemned the three as terrorists and insisted they should not be glorified as martyrs.

The 2002 bombs, followed by others in Jakarta in 2003 and 2004, and Bali again in 2005, forced Indonesia to shake up its security forces and rethink its hitherto lenient attitude towards Islamist militancy. It passed an anti-terrorism law, under which the Bali bombers were charged retrospectively. It stepped up its drive to prise from the army the job of curbing terrorism and other roles that are normally police work. With the help of the FBI and its Australian counterpart it created two specialist anti-terror units. One is a low-profile intelligence-gathering operation and the other, Detachment 88, a muscular police unit that swoops on suspected members of violent groups. The unit’s tactics of turning militants into informants by showering them with kindness (at one point its chief invited convicted terrorists to dine at his house) were controversial but effective.

Since then JI’s suspected military leader, Abu Dujana, has been caught and jailed. America is holding another important figure, Hambali—suspected of being the linkman to al-Qaeda—at Guantánamo Bay. But others remain at large, including Noordin Top, a Malaysian said to have formed a splinter group still keen on spectacular attacks. Also arrested after the first Bali bombs was Abu Bakar Basyir, JI’s spiritual leader. But he was freed after just 26 months and his conviction eventually overturned. He has continued spouting vile nonsense, recently claiming that most deaths in the 2002 bombs were caused by a nuclear weapon launched by the CIA.

Campaigners against the death penalty lamented the executions (see article). But that the authorities braved the consequences to carry out the sentences is the clearest sign yet of Indonesia’s increased will to tackle militancy. Much remains to be done. Most notably, dozens of JI-linked *pesantren* (Muslim boarding

schools) have been allowed to continue pouring fiery jihadist rhetoric into impressionable young ears. A corrupted and lax prison system gives jailed terrorists too much freedom—at one point the Bali bombers were allowed to use a laptop and mobile phone.

Terrorism analysts also say the police must keep a closer watch on localised sectarian conflicts, such as those between Muslims and Christians on Sulawesi and Ambon islands, which militants use to recruit members. JI has been weakened, but not destroyed. Last month five suspected JI members were arrested, accused of plotting to blow up Jakarta's largest fuel depot.

Indonesia's invigorated anti-terror fight forms part of a broader struggle to set the limits of political Islam in a country that is mainly Muslim but hugely diverse. Whereas the former Suharto regime contained militancy with an iron fist, Mr Yudhoyono's government must do so in a vibrant but often chaotic democracy in which hard-core Islamists are a minority but a vocal and sometimes thuggish one. On October 30th Rizieq Shihab, the leader of the Islamic Defenders' Front (FPI), a vigilante group, was jailed for 18 months for leading an attack on an inter-faith rally in Jakarta. The mild sentence drew complaints from secularist groups but it is another sign of the building momentum for enforcing the rule of law against self-appointed religious police.

The same day the parliament passed, after years of debate, a controversial "porn bill" sought by Islamists but backed by some secular parties in an attempt to look pious. Although campaigners managed to get the bill toned down, it still contains a clause vaguely supportive of public action against pornographic displays. Hindus, who form a majority on Bali and have traditions of sensuous art and dancing, fear the law will give vigilantes such as the FPI an excuse to attack them.

Ahmadiyah, an unorthodox Muslim sect, has suffered many such attacks on its members and mosques. Facing Islamists' demands to ban the sect and secularists' demands to protect its members' rights, Mr Yudhoyono made a weak compromise, allowing the group to exist but banning it from preaching its views. Indonesia's struggle to strike a just balance between faith and freedom is showing results but it remains a work in progress.

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Australia and the death penalty

All right then, just this once

Nov 13th 2008 | BANGKOK
From The Economist print edition

Mixed signals from Canberra over the Bali bombers

THE death sentences against the three Bali bombers put Australia—88 of whose nationals died in the attacks—in a difficult spot. It officially opposes capital punishment and is seeking clemency for three Australian drug-traffickers facing execution in Indonesia. Even some of the Bali victims' families spoke out against the shedding of more blood. Out of respect for such views, Indonesia delayed the executions during a five-day visit to their country this month by Prince Charles—heir to throne of Britain, Australia and several other countries that oppose capital punishment.

However, many Australians disagree with the government's policy and there has been an especial clamour for the maximum penalty to be paid by the Bali bombers. Ahead of the executions the prime minister, Kevin Rudd, was pushed to say that the bombers "deserve the justice that they will get". But within hours of the Bali three's execution, Mr Rudd's government announced a new campaign to press for a United Nations ban on capital punishment worldwide.

Frustrated at these mixed signals, Indonesia's foreign minister, Hassan Wirajuda, has asked Australia to respect his country's legal system. Indeed, the Rudd government's drive for a global ban on the death penalty will conflict with its desire to strengthen relations with Australia's Asian neighbours. Singapore, Malaysia, Vietnam, China and Japan all execute criminals and generally resent being told not to. Mr Rudd's campaign for a ban will win many backers, especially Europeans, but its chances are not good.

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Bhutan's newly crowned king

Crowning glory

Nov 13th 2008 | THIMPU
From The Economist print edition

A new king in a new democracy

IN THE mountainous forests above the Thimpu valley, the end-point of a five-day, guided trek through Bhutan for rich foreign tourists, lies the only big construction site in the capital of the isolated Himalayan country. The world's youngest democracy is building houses for its parliamentarians. The former king, Jigme Singye Wangchuk, shocked his people in late 2006 by stepping down, decreeing the establishment of democracy and handing over to his son, Jigme Khesar Namgyel Wangchuk. Most Bhutanese would have preferred to preserve royal rule, but loyally obeyed the king's order to rule themselves.

This month the reluctant delegates and tens of thousands of other Bhutanese flocked to the Tashichho Dzong, a white-walled fortress and monastery, to celebrate the coronation of their new 28-year-old king. The contrast with neighbouring Nepal, where this year a much-reviled monarch was given his marching orders, could not be starker. Jigme Khesar, like his father before him, is hugely popular.

AP

The king of happiness

The new king, the fifth of the 100-year-old dynasty, pledged to follow the path of democratisation and development embarked on by his 52-year-old father. The first general elections were held in March. The staunchly royalist Bhutan Peace and Prosperity Party won 44 of the 47 seats in the new parliament.

The last king in South Asia is likely to be guided by his father and his idea of an alternative to Gross Domestic Product as a measure of national progress: Gross National Happiness (GNH). A pilot survey conducted earlier this year by the Gross National Happiness Commission (formerly the planning commission) suggests that things are going rather well: more than two-thirds of Bhutanese could be classed as being happy.

But even Shangri-La has its problems. Despite big strides in development, particularly education and health, Bhutan suffers ills such as corruption, unemployment and alcoholism. One of Bhutan's three ethnic groups, the Nepali-speakers, concentrated in southern Bhutan, are still marginalised. Tens of thousands fled to Nepal from 1988-93. More than one-eighth of the 1990 population are still abroad.

Still, nothing suggests that more than a minority of those left behind disagree with the king's choice of happiness over other goals as the guiding principle of Bhutan's development philosophy. The former kingdom's 635,000 citizens are mostly poor subsistence farmers. The UN Development Programme's human-development index ranks Bhutan 133rd out of 177 countries. But the "Happy Planet Index" of the New Economics Foundation, a London-based think-tank, ranks Bhutan 13th.

For now, the four pillars of GNH—sustainable development, environmentalism, good governance, and the preservation of Bhutanese cultural values—appear to be little more than laudable common sense. They conceal, however, some controversial debates, such as who defines traditional culture and whether it includes the ethnic minorities. But GNH is developing its own cult following. Adherents will gather in Thimpu later this month for the 4th GNH Conference in Thimpu.

Unless parliament votes for his abdication with a 75% majority followed by a referendum, the charismatic king will rule until 2045. Most people seem relieved, trusting him to guide them. The admiration extends to other areas. "He is awesome," says Soenam Dorjee, a Thimpu resident who regularly teams up against the king's basketball team. "His favourite shot is two feet from the three-point line. And you know what: he sinks them," Mr Dorjee says, and smiles, happily.

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Kazakhstan's "New Silk Road"

Eyes on the road

Nov 13th 2008 | ALMATY
From The Economist print edition

Becoming Central Asia's crossroads

THE authoritarian leadership of Kazakhstan has long hankered after international recognition. It sets great store by league tables, wanting the country to become one of the world's top oil producers and to be counted among its 50 most competitive economies. Helping thwart their ambitions has been Kazakhstan's creaking infrastructure, particularly its roads.

A few main road arteries have been refurbished—eg, from Almaty, the largest city, to the capital, Astana and to Bishkek, capital of Kyrgyzstan. But some 60% of roads need big repairs. Even where they have been fixed, notably in the big cities, the work is often so poor that they need to be repaved two or three years later.

But in this respect too the government is thinking big. This week the Asian Development Bank (ADB) announced a $700m loan to improve part of a 2,715km (1,700 mile) road from China in the east to Russia in the west. It is part of a bigger, $6.7 billion project, co-financed by other international institutions, due to be completed by 2015. Juan Miranda of the ADB says it will increase travel speed by 40%, and reduce freight-transport costs by half. Despite the current financial crisis, road-freight transport is forecast to grow by about 10% a year, and the number of vehicles by 5%. The road should be a big boost to the economy of Kazakhstan and the region: "a new Silk Road", boasts Mr Miranda.

It may even help Kazakhstan's abysmal ranking in another league table: for road-safety standards. More than 2,000 people are killed in accidents every year. Between 2005 and 2007, this figure has gone up by more than 19%, thanks to speeding and a lack of security barriers, lighting, and police oversight. Poor medical facilities on the long roads of a vast country make it more likely accidents are fatal.

The authorities, conscious that this is hardly the record of a developed country, are at last making serious efforts to improve road safety. Since August, traffic rules have been tightened and the requirement to wear a seat belt is being enforced. Fatality rates are already said to have dropped by around 10%.

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Low-level unrest in China

For hire

Nov 13th 2008 | SANYA, HAINAN ISLAND
From The Economist print edition

Grumpy taxi-drivers; a tough winter

IN A recent article China's prime minister, Wen Jiabao, gave warning of social turbulence if the economy failed to grow at a "relatively fast" speed. In the tropical resort city of Sanya a strike by hundreds of taxi drivers is a low-level instance of the kind of turbulence he has in mind. Violence has flared and tempers are running high.

China has weathered patches of growth well below recent double-digit rates before without major upheaval—notably after the Asian financial crisis of the late 1990s. But the spread of mobile telephones and internet access has made it much easier for the disgruntled to organise. The strike in Sanya, which began on November 10th, broke out a few days after a similar one in the south-western city of Chongqing, 1,200km (750 miles) away. Around the same time as Sanya's protest began, a smaller taxi strike was also reported in Gansu province in the north-west.

Both in Chongqing and in Sanya, taxi-drivers attacked cars that refused to join the strike. The official press said drivers in Chongqing damaged at least 20 vehicles, including three police cars. In Sanya it reported that 15 cars were attacked, resulting in the arrests of more than 20 people. Since the strike began in Sanya taxi-drivers have been gathering outside the city-government headquarters. By November 11th their numbers had swollen to about 300, according to the state-owned news agency Xinhua. "The government is completely corrupt," says one of the protesters.

The taxi strikes share a common theme: what drivers say are excessive fees demanded from them by their companies, as well as the failure of local governments to stop unlicensed cabs, which are undermining their business. Taxi-drivers are a powerful constituency in China, since many middle-class city-dwellers depend on them, and they can mobilise quickly and paralyse traffic.

To assuage them, Chongqing's Communist Party chief, Bo Xilai, a Politburo member, held a meeting with strikers. Even more unusually, he allowed live coverage of the event, though by then most drivers had returned to work. In Sanya the acting mayor apologised to the drivers, but the strike dragged on into November 13th. The drivers in Gansu agreed to end their strike after the authorities promised to crack down on unlicensed taxis.

Officials in Guangdong province in the south, hit by falling demand for China's exports, are also trying to prevent the spread of unrest by meeting protesters' demands. In Dongguan, a big manufacturing centre, the authorities agreed last month to pay the salaries owed thousands of workers made jobless when a toy factory closed. In eastern Jiangsu province, officials have held talks with workers in the city of Jiangyan after they blocked roads and besieged government offices to protest about job insecurity at their diesel-engine factory. The coming months could be troubled.

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The Chinese Peasant Olympics

Anyone for toss the laptop?

Nov 13th 2008
From The Economist print edition

The Olympic spirit reaches the countryside

THEY recall a hybrid of the Olympics and a school sports day. In the swimming, participants have baskets of balls attached to their heads or carry a torch. Cyclists have bags weighing up to 65kg (140lbs) strapped to their seats. There is a four-legged race with three people. And, of course, there is “the water-carrying contest to protect the seedlings amid drought”, a perennial favourite.

The Chinese Peasant Olympics, which finished this month in the southern city of Quanzhou, have been held every four years since 1988. This year they attracted a record 3,500 entrants from across China and Taiwan. Quanzhou invested more than 1 billion yuan ($145m) to build 15 venues for the tournament. More than 180 events ranged from table tennis and chess to traditional Chinese activities such as dragon-boat racing, tai-qi and lion dancing, and more exotic sports, such as food-carrying, kite-flying and tyre-pushing.

The games provide a way for the authorities to honour farmers’ collective toil. Many events require co-operation rather than competition, to emphasise the goal of “harmony”. The fancy opening and closing ceremonies also helped make the lavish summer Olympics in Beijing look less outlandish to the average provincial paddy worker.

This year saw a new event, the traditional Yangko folk dance. Yet some contestants fretted that other changes would be needed before 2012. There were complaints that the cycling events needed updating, with so many peasants now owning motorcycles. One competitor also complained that he had failed to make the rice-planting final because he was more used to a machine these days.

With ever more peasants migrating to the cities, there is also a worry that the games are losing some of their resonance. Time to consider a “navigating an overloaded taxi at high speed while using two mobile phones” event?

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South Africa and the world

The see-no-evil foreign policy

Nov 13th 2008 | JOHANNESBURG
From The Economist print edition

Why post-apartheid South Africa, once a shining beacon of human rights, is cosying up to nasty regimes around the world

Panos

ANOTHER African summit, another disappointment. Any hope that the change of leadership in South Africa might bring change across the border in Zimbabwe has proved in vain. The new president, Kgalema Motlanthe, may sound tougher than his ever-appeasing predecessor, Thabo Mbeki. But he seems no more willing to turn the screws on his errant northern neighbour, Robert Mugabe.

Regional leaders meeting on November 9th all but kowtowed to Mr Mugabe over the terms of September's power-sharing deal with the opposition. This was intended to arrest the country's political and economic collapse but has foundered, particularly over who should run the interior ministry, and by extension the police. Morgan Tsvangirai, who won more votes than Mr Mugabe in the presidential poll in March, says his Movement for Democratic Change (MDC) should be in charge, given that the ruling ZANU-PF controls the army and intelligence organs.

Mr Tsvangirai has good reason to be wary. Human-rights groups report that Mr Mugabe's henchmen are still persecuting MDC supporters (pictured above); and riot policemen have been back on the streets to break up anti-government protests. Yet leaders of the Southern African Development Community (see map) say the interior ministry should be shared—an unworkable proposal rejected by Mr Tsvangirai. Mr Mugabe seems ready to appoint a cabinet regardless.

The MDC, long critical of Mr Mbeki's mediation, has been calling for others to step in. It is not alone. South Africa's handling of the Zimbabwean crisis has drawn sharp criticism from many corners. Indeed, among the international human-rights fraternity, post-apartheid South Africa—the democratic, multicultural "rainbow nation" forged by Nelson Mandela—is once again regarded as something of a pariah. Its gentle treatment of Mr Mugabe, once justified by fear of instability on South Africa's borders, has become part of a wider pattern of alignment with some of the world's least savoury regimes.

In the UN Security Council, South Africa has voted against imposing sanctions not only on Zimbabwe but also on Myanmar's military junta (after last year's crackdown on peaceful protesters) and Iran (for violating nuclear safeguards). It is now leading efforts to suspend the International Criminal Court's prosecution of Omar al-Bashir, Sudan's president, for alleged genocide in Darfur.

Its record in the UN Human Rights Council is no better. It has voted to stop monitoring human rights in Uzbekistan, despite widespread torture there, and in Iran, where executions, including those of juvenile offenders, have soared. "Never in my wildest dreams did I believe South Africa would play such a negative role," says Steve Crawshaw of Human Rights Watch, an international monitoring group.

Shortly before taking over as South Africa's first democratically elected president in 1994, Mr Mandela vowed that "human rights will be the light that guides our foreign affairs." After decades of isolation under an apartheid government, Africa's richest country would return to the world stage as a "beacon of hope" for the oppressed. And it all seemed to begin so well. At home, the new government brought in one of the most progressive constitutions in the world, prohibiting every kind of discrimination and guaranteeing not only the classic civil liberties but also a right to adequate housing, reproductive health care and even to "have the environment protected". The death penalty was abolished; the abandonment of nuclear weapons confirmed.

Abroad, South Africa launched itself as one of the region's leading peacemakers, mediating in conflicts across Africa and sending troops into Darfur, Burundi, the Central African Republic and Congo. It was also the leading light behind the New Partnership for Africa's Development, with an African peer-review system to promote democracy and good governance. Along with Brazil, China, India and Mexico, South Africa is now one of five emerging countries regularly invited to meetings of the G8, the group of the world's richest states. And whenever reform of the UN Security Council comes up, its name is always among those mooted for a possible new permanent seat.

But in recent years, Mr Mandela's promised beacon has begun to look decidedly dim. Since 2006, when South Africa secured a (non-permanent) seat on the Security Council for the first time, it has been chumming up with China, Russia and other authoritarian regimes to water down or block virtually every resolution touching on human rights. It argues that the Security Council (dominated by the five veto-wielding permanent members) should not concern itself with such issues, leaving them to the Human Rights Council (on which developing countries have a controlling majority). But that body has proved as ineffectual as its predecessor, stifling—with South Africa's help—criticism of the world's worst tyrants.

Why has democratic South Africa done so much to squander its once acclaimed moral leadership? In truth, the ruling African National Congress has always been cosy with some dictators, such as Libya's Muammar Qaddafi and Cuba's Fidel Castro, even under Mr Mandela—largely out of gratitude for past help during the struggle against white rule.

Another reason for its actions can be found in Mr Mandela's experience in 1995, when he found little support in Africa for action against Nigeria's former military junta. A bigger reason lies in South Africa's ambivalent sense of identity, with one foot in the rich world, where its main economic interests continue to lie, and the other in the poor one, with which many of its people identify. Even after the end of white rule, some of South Africa's neighbours regard it as something of a Trojan horse for the West. Hence its desire constantly to affirm its African credentials while playing down any hegemonic ambitions.

South Africa has never sought to define itself as a great force for good in the world, says Aziz Pahad, deputy foreign minister until his resignation in September. Like almost every other country, its foreign

policy is based not on morality but primarily on its own national interest. And that, says Mr Pahad, lies in creating a new and more equitable world order.

Thus South Africa's earlier talk about setting Africa's house in order has given way to pushing for more representation of poorer countries in multilateral institutions such as the UN Security Council, the IMF and the World Bank. South Africa's ambition to gain a greater voice means making common cause not just with its African neighbours but also with the rest of the poor world, democratic or not.

Many South Africans say that rich countries' strictures on democracy and human rights will carry little moral force until poorer countries have a bigger say in running the affairs of the world. Not all agree. Turning a blind eye to oppression abroad is "a betrayal of our own noble past", argues Desmond Tutu, a Nobel peace-prize winner and a hero of the struggle against white rule. "If others had used the arguments we are using today when we asked them for their support against apartheid we might still have been unfree," he says.

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Congo

Beware of a stampede to war

Nov 13th 2008 | KINSHASA
From The Economist print edition

The UN may send more troops to Congo. Would they do any good?

WHEN elephants fight, goes a Swahili saying, it's the grass that suffers. And so it is in eastern Congo, where civilians are being trampled in a terrible way in fighting involving Congolese troops, followers of the rebel leader, Laurent Nkunda, and an assortment of nasty militias. Some 250,000 people have been displaced. Reports of massacres, rape, cholera and hunger are multiplying. Aid-workers say some 100,000 refugees are cut off from any help. Worse may come if the instability turns once again into a wider war.

The cane-wielding Mr Nkunda, a dissident Tutsi general with ties to Rwanda, has led his rebels against the weak Congolese government for years. He declined to take part in the political process that led to the election of Joseph Kabila as president in 2006. He says he is defending fellow Tutsis against murderous Hutu militias who, he says, are being supported by the government in Kinshasa.

His soldiers have been poised to take the lakeside town of Goma, the provincial capital and once a tourist destination. Congo's army, backed by a thin blue line of UN peacekeepers, is in no shape to resist him. It was supposed to be reconstituted from the various units, militias and rebels that fought in the civil war between 1998 and 2003. But poorly paid government soldiers have scattered as rebels advanced, killing and looting the very people they were supposed to be protecting.

General Nkunda has threatened to march across Congo to Kinshasa to overthrow Mr Kabila if he refuses to start formal talks with the rebels. That sounds fanciful: Congo, nearly the size of western Europe, is covered in thick jungle and has almost no roads. But Rwandan-backed rebels did take Kinshasa once before, in 1997, sweeping away the old dictator, Mobutu Sese Seko, and installing Mr Kabila's elephantine father, Laurent. Rwandan- and Ugandan-backed forces came close to repeating the upheaval a year later, provoking the awful civil war that sucked in forces from several nearby countries including Angola, Namibia and Zimbabwe.

General Nkunda knows that merely threatening such an assault will spread dismay and play on popular dissatisfaction with Mr Kabila's government. "Kinshasa may be a dream but Nkunda seems intent on causing more trouble if he doesn't get what he wants," says a diplomat.

Outsiders have so far done little to help. United Nations officials have asked the Security Council to approve the deployment of 3,000 more peacekeepers to bulk up the 17,000-strong force already spread

across Congo. But it could take months to raise the extra troops and deploy them. It is unclear, moreover, how far UN soldiers are really able or willing to protect civilians. Peacekeepers in Kiwanja did not prevent a massacre of dozens last week.

The European Union, which has two 1,500-strong battlegroups ready to deploy within days, has been deaf to appeals for intervention. Neighbours may yet act; Angola has some troops in Congo, training the army; the regional body, the Southern African Development Community, said it was ready to send troops.

A useful idea might be to get Rwanda to hold back General Nkunda. This is not easy, not least because its relations with some European countries have taken a bad turn (see article). Diplomatic pressure, especially from Rwanda's close friends, Britain and America, may be having some effect: General Nkunda has not yet mounted his attack on Goma. But for how long will the elephant be restrained?

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Rwanda and Europe

Judicial politics of a genocide

Nov 13th 2008 | NAIROBI
From The Economist print edition

The arrest of a senior Rwandan official causes a storm

AFP

Kagame and Kabuye out of fatigues

ON APRIL 6th 1994 a surface-to-air missile brought down an executive jet preparing to land in Kigali, killing the Rwandan president, Juvenal Habyarimana, and the president of neighbouring Burundi, Cyprien Ntaryamira, together with its French air crew. This attack is not just of historical interest as the starting point of the country's genocide, in which some 800,000 Tutsis and moderate Hutus were slaughtered by Hutu extremists; it is now the subject of an international judicial and diplomatic row.

Acting on a French arrest warrant, German authorities on November 9th detained Rose Kabuye, a former guerrilla colonel who is a senior aide to Rwanda's President Paul Kagame. He had been planning to make a pitch for investment in his tiny African country; instead he found himself denouncing his German hosts and visiting Ms Kabuye in prison outside Frankfurt.

She was in good spirits, he reported, and ready to be extradited to France to face her accusers. Mr Kagame, who had immunity as a head of state, insisted that she should also have been protected as a member of his official party, even though she had arrived ahead of him. The German ambassador to Rwanda was expelled until the case was "resolved".

Ms Kabuye is the first Rwandan official to be arrested under warrants resulting from a French judicial inquiry into the 1994 crash and a separate Spanish investigation into the deaths of Spanish citizens after Mr Kagame's rebels swept the *génocidaires* from power. Taken together, much of Rwanda's senior leadership, including a commander of the United Nations peacekeeping force in Darfur, face arrest.

France and Rwanda have long traded accusations over the events of 1994. France believes Tutsi rebels

led by Mr Kagame were responsible for killing Mr Habyarimana because, they say, he was close to signing a peace deal with the rebels. Rwanda, for its part, accuses France of complicity in the genocide. It claims that France helped form Mr Habyarimana's murderous government and gave military support to those who later led the genocide. Moreover, its says the French peacekeeping mission, "Operation Turquoise", stood by while the mass killing took place, and created a buffer that allowed Hutu killers to escape into Congo—some of whom contribute to today's troubles in eastern Congo.

Rwandan officials say they are likely to retaliate by issuing warrants for the arrest of French army officers and politicians—among them the former prime ministers Edouard Balladur, Alain Juppé and Dominique de Villepin. The African Union has voiced concern over Ms Kabuye's arrest. International justice, it seems, is in the eye of the beholder.

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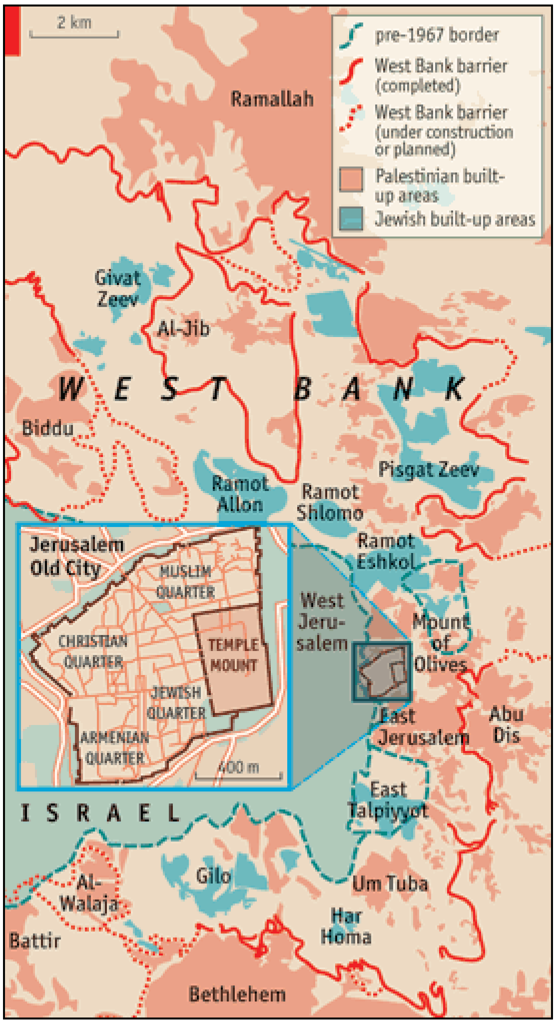
Jerusalem's politics

Money, faith and votes

Nov 13th 2008 | JERUSALEM
From The Economist print edition

A secular entrepreneur is elected to run the holy city



THE hollowness of Israel's rhetoric about "united Jerusalem" is never starker than on local election day, when the city's 537,000 adults, together with the rest of Israel, can go to the polls to pick their new mayor. Among Jerusalem's Palestinians, who make up some 30% of the citizenry, hardly anyone bothers to vote. In East Jerusalem, the mainly Arab part of the city captured and annexed by Israel in 1967, polling stations in schools and public buildings stay yawningly empty, apart from a trickle of municipal employees and their families.

This time was no different, except that most of the Palestinians who did vote in Jerusalem on November 11th gave their support to Arkady Gaydamak, a colourful but mysterious ex-Russian oligarch who has been trying to make his way in Israeli politics despite a French warrant for his arrest on gun-running charges. With the help of Palestinians, he got a paltry 3.5% of the overall vote. Palestinian commentators attributed his modest popularity in their community not just to his wealth but to the fact that he doesn't look Jewish.

This could hardly be said for the man who came second, with 43% of the vote. Meir Porush sports a long and lush grey beard, and long sidelocks too, which he hoists up under his big black hat. He is every inch a *haredi*, or ultra-Orthodox Jew, which he claimed was why the city's shrinking non-*haredi* Jewish population was so doggedly determined to block his way to the mayor's office.

On paper, Mr Porush was to the mayoralty born. His father and his grandfather before him served as deputy mayors of Jerusalem, squabbling ferociously but in the end always compromising somehow with the thoroughly secular Teddy Kollek, mayor from 1965 to 1993. The 53-year-old Meir, the father of 12, did his stint on the city council, too, before moving on to national politics as a member of parliament.

The man who has won the invidious job of running Jerusalem is a 49-year-old high-tech millionaire, Nir Barkat. He and his ecstatic supporters insist they weren't fighting Mr Porush for who he is, but for whom he inescapably represents; the city's large and fast-growing *haredi* minority. Safe with 52 % of the votes after a tense all-night count, Mr Barkat promised to be everyone's mayor. But he campaigned—and won—as the candidate who can rescue Jerusalem from a takeover by the *haredim*.

Jerusalem for years has been losing young, secular citizens, who often cite creeping "haredisation" as their reason for leaving. A civil-service and university town, it is short of industry and investment. Many of the *haredi* families are poor, because the men choose to study in religious seminaries rather than work. Many Palestinians are poor, too. As a result, despite constant efforts to raise philanthropic funds abroad, the city is chronically short of money.

This accounts objectively for some of the secularists' gripes. Non-religious interests are underfunded in Jerusalem not just because money is tight, but because of the pro-*haredi* bias under the outgoing ultra-Orthodox mayor, Uri Lupolianski—especially in the allocation of land for schools and synagogues for the *haredim*.

And secular grievances are also driven by a changing cultural climate. When the city inaugurated a striking new bridge earlier this year, young girl dancers were swaddled top-to-toe in dark cloth for reasons of religious modesty. *Haredim* are steadily encroaching on formerly secular or mixed suburbs. Families remaining in them feel increasingly isolated and uncomfortable, especially on the sabbath. Granted, the violent confrontations over roads, cinemas and clubs that used to take place each Saturday are now a rarity. Nightlife is lively, and undisturbed. But the threat to their lifestyles, say many secular Jews, is more insidious and much more pervasive.

Mr Barkat waited five long years for his victory, on the opposition benches of the city council. In 2003 he was beaten by Mr Lupolianski, the *haredi* parties' candidate but not a professional *haredi* politician. Then, Mr Barkat blamed secular apathy. The turnout was 38%, which, factoring out the Palestinian boycott, was actually much higher than the national average.

This time, with both sides vigorously knocking on doors and Mr Barkat's campaign even busing ex-Jerusalemites up from Tel Aviv to vote, 41% of eligible voters turned out, or about 60% of the city's Jews. In Tel Aviv and Haifa, by comparison, turnout was below 40%. In both cities the incumbents were returned.

Mr Barkat benefited from a vicious rift in the *haredi* camp, with the rabbi of one large Hasidic sect instructing his followers to vote for the secular candidate rather than for Mr Porush. Mr Barkat was supported, too, by Jerusalem's modern-Orthodox community, many of whom liked his strongly nationalist opinions. Asked on November 12th about the call by the outgoing prime minister, Ehud Olmert, for Israel to cede the Arab areas of Jerusalem to a future Palestinian state, the new mayor said it was "a very serious mistake".

But then, Mr Olmert himself would have doubtless said the same when he was elected mayor of Jerusalem in 1993. After ten years in that job, and five more as deputy prime minister and prime minister, he knows it is not so simple.

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The Palestinians

The return of blood and anger

Nov 13th 2008 | GAZA CITY
From The Economist print edition

And the political cost of ending the ceasefire in Gaza

THE angry crowds are back on the streets of Gaza, along with the corpses wrapped in symbols of martyrdom and the militiamen in battle fatigues firing their guns. For five months the teeming Palestinian enclave has been quiet, thanks to a ceasefire agreed in June by Israel and Hamas. But that may all be coming to an end.

The new cycle of violence, rocket-firing, skirmishes and economic blockade started on November 4th, when Israeli forces made an incursion to destroy a tunnel which, they say, was to be used to abduct a soldier. In the view of Ehud Olmert, the outgoing Israeli prime minister, it is not a matter of whether full-scale hostilities resume, but when.

Israeli-Palestinian violence has a way of feeding itself. But both sides may have good political reasons to try to hold back. Israel will hold general elections in February. Neither Tzipi Livni, the head of the ruling Kadima party, nor Ehud Barak, the Labour defence minister, would relish going to the polls with rockets falling on Israeli towns—and face accusations that they are soft on security.

Hamas has benefited from the polarisation brought about by years of bloodshed. But the Islamist movement may yet decide that, for now, a new round of fighting could weaken its hand in the contest with the more secular Fatah movement of President Mahmoud Abbas. It has expressed hope that the new American president, Barack Obama, will be open to dialogue with Hamas.

Hamas and Fatah, which control the Gaza Strip and West Bank respectively, were supposed to hold reconciliation talks in Cairo on November 17th. But Hamas pulled out because of a dispute over the release of hundreds of Hamas sympathisers and activists rounded up by Mr Abbas's forces, which are being bolstered with American and Israeli help. The last attempt at a power-sharing deal, brokered by the Saudis in February 2007, collapsed within months and led to a brief civil war and Fatah's loss of Gaza.

The main issue in the coming months will be the status of Mr Abbas, whose presidential term ends in January 2009. Fatah says he should stay on so that presidential and parliamentary elections can be held simultaneously in 2010. Hamas says doing so would make Mr Abbas a “president by force”.

Hamas does not have the strength to challenge Fatah in the West Bank. But it could appoint a rival president in Gaza, deepening the rift. The question for Hamas is not just whether to take on the Israelis, but whether to risk a new round of fighting among Palestinians.

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France's president

Is Sarkozy a closet socialist?

Nov 13th 2008 | PARIS
From The Economist print edition

A question that worries a few and excites others

Illustration by Peter Schrank

WITH delicious unintended symbolism, the French Socialists are meeting in Reims, capital of champagne country, between November 14th and 16th to elect a new leader. The party is deeply split by personal rivalries, with four front-runners for the top job. One contender, however, will not appear on the ballot, even if on recent form he might deserve to: Nicolas Sarkozy, the centre-right president.

Mr Sarkozy was elected last year on a promise to get the French back to work, to allow them to earn more, to end the welfare culture and to encourage risk and reward merit. But recently the president has sounded a different note. He has declared that “laissez-faire capitalism is over” and railed against the “dictatorship of the market”. He is setting up a “strategic national investment fund” to take stakes in French companies so as to protect them from foreign predators. His prime minister, François Fillon, has threatened to nationalise banks unless they lend more to companies. And Mr Sarkozy has also pledged to create 100,000 state-subsidised jobs of just the sort favoured by a former Socialist government, which he denounced vigorously during his election campaign.

This lurch to the left has not gone unremarked by real socialists. Martin Schulz, German leader of the Socialist group in the European Parliament, has congratulated the French president for “speaking like a real European socialist”. It was a taunt that the president chose, uncharacteristically, not to dismiss. “Have I become socialist?” he wondered. “Perhaps.” The ambiguity is such that some on the left now see a need to reclaim their ideology. A testy Pierre Moscovici, a French Socialist, insisted to the newspaper *Le Parisien* recently that “No, Mr Sarkozy is not a socialist.”

Part of Mr Sarkozy’s enthusiasm for state intervention can be explained by the financial crisis. With even the Americans and British bailing out companies with public money, the state is back in favour in the least likely places. The word “French”, which during the invasion of Iraq in 2003 was sometimes employed in America as an abusive synonym for “spineless”, is now more likely to be used to mean “socialist”. When Jim Bunning, an American senator, heard that the government had taken control of two big American mortgage lenders he said he felt as if he had “woken up in France”. In some ways, indeed, Mr Sarkozy is simply returning to French interventionist tradition, with the economic crisis providing a ready excuse.

Yet the Americans and British consider such policies least-bad solutions, to be reversed as soon as possible. Mr Sarkozy actually believes in an activist state in certain areas. He has long advocated a forceful industrial policy, for example, on the ground that “once the factories go, everything goes.” Well before the financial crisis, he championed, against German doctrine, a political counterweight to the European Central Bank. Such talk has delighted European socialists, who have found unlikely common

cause with the centre-right president. The same goes for his calls for a cap on executive pay and an end to golden parachutes, which might have been lifted from socialist scripture.

The more intriguing question is how far Mr Sarkozy will follow up his leftish-sounding rhetoric with concrete policies. So far, for pragmatic rather than ideological reasons, the French state has bailed out just one troubled bank: Dexia, a small Franco-Belgian institution. Certainly, Mr Sarkozy would not hesitate to do more. As finance minister in 2004, he rescued Alstom, an engineering giant, from bankruptcy; the firm recovered, and the state later sold its stake for a large profit.

In other cases, however, there seems to be more noise than results. When ArcelorMittal, a steel giant, announced the closure of part of a factory at Gandrange in eastern France earlier this year, Mr Sarkozy rushed to the scene with promises to keep the plant alive—even if it meant investing state money. Since then, however, ArcelorMittal has confirmed the partial closure, transferring nearly 600 workers elsewhere within the company.

Other examples abound. Earlier this year, Mr Sarkozy dropped in on angry fishermen in the port of Boulogne-sur-Mer, and promised a thorough review of European Union fishing quotas during the French presidency of the EU. France gives up this position at the end of December, yet nothing of the sort has happened. Or consider the curbs on executive pay. Mr Sarkozy threatened to legislate to enforce these, but he has since accepted a form of self-regulation in the shape of a code of good governance for companies.

Charitable observers would call Mr Sarkozy's approach pragmatic. He tries to find solutions, not to apply ideology. Confronted by angry workers in overalls or oilskins, he may think that he can save a factory or abolish fish quotas. But, in calmer moments, realism prevails. Launching his subsidised-jobs scheme last month, Mr Sarkozy declared: "We can't be ideological in the face of human misery."

Another explanation could be strategic. As recession beckons and joblessness rises, Mr Sarkozy cannot leave the plight of the unemployed to the left. The Socialists, under their new leader, may become bolder. He may also hope to thwart the rise of the anti-capitalist left under Olivier Besancenot, a revolutionary postman, just as he managed to squelch the far-right National Front during the presidential election by taking a hard line on immigration.

A third reason could be that Mr Sarkozy hopes to use state intervention in some areas as political cover to press ahead with more liberal policies in others. When he announced his new state-subsidised jobs programme, for example, he also said that he would loosen the rules to make it easier for small firms to employ temporary workers. Shortly afterwards, his government said that it would make it legal to work until the age of 70.

It is a delicate path to tread. Mr Sarkozy cannot plausibly head off the anti-market left unless there is enough substance behind his fiery talk. Yet too much and he will lose those who backed him precisely because he was ready to tell the French that they could not live beyond their means. So far the French seem to like what he is doing: in November, his popularity climbed eight points to 49%, according to Ipsos, a pollster. And Mr Sarkozy is nothing if not agile. But even he will find it hard to straddle the entire political spectrum.

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Germany's economy

A little stimulus

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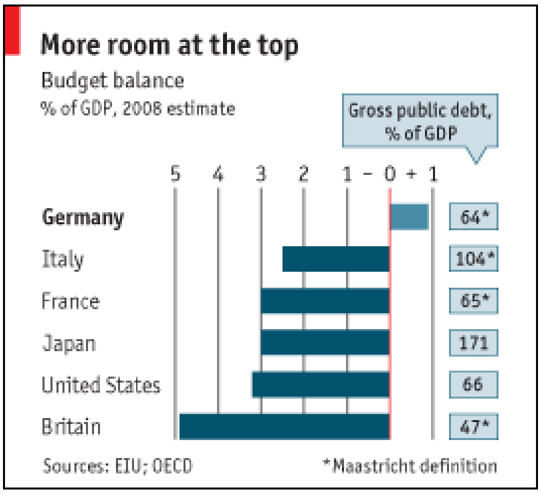
Even in recession, Germany is the last of the small spenders

CHINA is to spend $586 billion to prop up growth. Japan plans $275 billion-worth of economic stimulus. America's government is expected to pump out still more cash. Into this fiscal pot Germany has tossed a few coins: it has unfurled an "umbrella for jobs", 15 small-bore measures that include €12 billion ($15 billion) of fresh spending over two years, or roughly 0.25% of GDP. This will trigger €50 billion of investment, promised Chancellor Angela Merkel. But pressure is on the world's third-largest economy, which sank deeply into recession in the third quarter, to do more.



The German budget was close to balance in 2007 and may be in surplus this year, a claim few other rich countries can make (see chart). The world's biggest exporter of goods boasts a current-account surplus that is expected to reach 7% of GDP this year. Rather than spend, Germans have been paying higher taxes and exercising wage restraint to make their firms more competitive: consumption has been flat. This suggests that Germany should be among the first to seize the Keynesian moment that the financial crisis has brought about. Its trading partners certainly think so. Germany "has the possibility to use tax policy to support demand," says the European Union's economics commissioner, Joaquín Almunia.

So what holds it back? Spending packages enacted to fight slumps in the 1970s produced little but new debt. Since then the prevailing wisdom has been that they do not work. Governments that boost spending in bad times rarely pare it back later. When people see that debts, and thus taxes, are heading up they tend to save more rather than spend, says Joachim Scheide of the Kiel Institute for the World Economy (this phenomenon is known as Ricardian equivalence). The grand coalition of Ms Merkel's Christian Democratic Union (CDU) and the Social Democratic Party (SPD) was set on balancing the federal budget by 2011. The target will not be met, the government admits, but that is no reason to splurge. Even the term economic package is taboo. The umbrella "is not a stimulus package of the old style," insists the finance minister, Peer Steinbrück.

Yet resistance is crumbling as the economy wobbles. On November 12th the council of five economic "wise men", which has long defended fiscal prudence, called for a "cyclically justified growth policy" to fight the recession. The government should spend a lot more than planned—0.5-1% of GDP—on first-aid measures that would also improve the economy's long-term health. Investment in transport and early education are top of its list. While the recession is on, the government can let the deficit expand to cover the cost; thereafter it should cut spending elsewhere or boost revenues.

Ms Merkel's umbrella is far from what the wise men have in mind. It includes help for the car industry, subsidies for energy conservation and more lending to small and medium-sized companies by KfW, a state-owned bank. But Ms Merkel faces an election as well as a recession: next September she will fight to keep her job against the SPD's Frank-Walter Steinmeier, now foreign minister. By then the question for both may be not whether to administer more fiscal medicine to a sickly economy, but how.

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Higher education in Italy

A case for change

Nov 13th 2008 | ROME
From The Economist print edition

Universities desperately need reform—yet resist change

EPA

Dreamy student days

“TUTTA LA VITA DAVANTI” (“Your Whole Life Ahead”), a recent Italian movie, opens with the voice of a young woman defending her thesis. The camera dwells on one wrinkled visage after another, until it becomes clear that the entire examining board is made up of octogenarians—and a chuckle of cynical recognition runs through the cinema audience.

The retirement age for Italian university teachers is 72. Mariastella Gelmini, education minister in Silvio Berlusconi’s right-wing government, plans to reduce it, though only to 70. And this is just one of a host of reforms she is seeking to make to one of the worst managed, worst performing and most corrupt sectors in Italy.

Italian universities are not over-funded. According to the OECD rich-country think-tank, each student in 2005 cost some $8,026, well below the average of $11,512. But the figure for Italy does not include private universities. And few critics believe that a shortage of cash is the biggest problem for state-run higher education.

Most Italians point instead to the overweening power of the *baroni* (barons), or tenured professors with the power of academic life and death. Many treat their faculties as personal fiefs. Nepotism and favouritism are rife: only this week news emerged of a university rector who, the day before he retired on October 31st, signed a decree to make his son a lecturer. Research by students at Federico II University in Naples found that 15% of teachers had a relative on the university staff. At Palermo University, as many as 230 teachers are reported to be related to other teachers.

The creation of jobs for relatives and friends has helped to inflate the number of Italian academics. According to Ms Gelmini, 13,000 junior posts have been advertised in the past seven years, yet 26,000 have been filled. Cronyism has also led to a proliferation of courses and departments. Italy has 37 courses with but a single student; 327 faculties have fewer than 15.

Some valuable research and inspirational teaching are done in Italian universities. But the more common pattern is of a uniform mediocrity. Not one Italian institution is in the top 100 of the 2008 Times Higher Education world university rankings. The *baroni* wield considerable influence over governments, particularly of the centre-left, and have used it to bury most attempts at reform.

The need for change is now pressing. Five universities are, in effect, bankrupt. The system as a whole is manifestly failing the economy. Only 17% of Italians between 25 and 34 have a tertiary qualification, compared with an OECD average of 33%. The main reason is a shocking dropout rate of 55%, the highest in the rich world.

Judging that students were being asked to stay at university for too long, Mr Berlusconi's previous government introduced optional, three-year degree courses. But employers say that graduates of these shorter courses are not good enough. Universities are not imparting enough learning within a reasonable time.

Most of Ms Gelmini's reforms will be included in two bills that have yet to be formally published. But earlier this month she won cabinet support for an initial measure to alter the selection process for university teachers and researchers in order to prevent abuses; to set aside more cash for student grants and accommodation; and to mitigate the effects of earlier cost-cutting legislation by raising the number of lecturers and researchers who can be hired for every one that retires.

All this might seem good news for students and teachers. Yet students have staged protests around the country. This week the main trade union federations planned a national strike, though one of them pulled out at the last minute. The opposition argues that no good will come of reforms inspired by cost reduction. But the government retorts that Italy's ultra-low birth rate has created what Ms Gelmini calls "an historic opportunity" to raise quality while spending less. At least her plans deserve a fair hearing.

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Economist.com WORLD EUROPE

Eastern Europe and America

Looking west, hopefully

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Eastern Europe awaits a new American president nervously but in hope

DETAINING the next president of the United States for three hours in what an eyewitness called a “malodorous” small room at an airport in the provincial Russian city of Perm looks, in retrospect, to have been a pretty bad idea. No matter that the Kremlin muttered an apology for delaying Barack Obama, along with his mentor on the Senate Foreign Relations Committee, Richard Lugar, in August 2005. The hold-up was blamed on a muddle over paperwork—although some Russia-watchers suspected it was a calculated Kremlin snub to the Republican Mr Lugar.

Mr Obama now plays down the episode, but his first-hand experience of the Russian bureaucracy’s capacity for at best capricious incompetence and at worst vindictiveness could yet prove telling. His team of hundreds of foreign-policy experts ranges from those who see the Bush administration’s policy as dangerously confrontational to those who think it too soft. Michael McFaul, a Stanford academic who has become a caustic critic of the Kremlin, is an influential Obama adviser. But it remains to be seen how many people Mr Obama will pick from his own team, and how many from the Hillary Clinton camp of experienced Russia hands.

The Democratic Party is in general rather less hawkish than many of Mr Obama’s senior advisers. Yet the prosaic truth is that, whoever secures the top jobs in the new administration, American policy towards eastern Europe is likely to be shaped mainly by events and bureaucratic drift, not personalities. Barring a new crisis (such as another war in Georgia), eastern Europe is unlikely to get anything like as much attention as the economy. Even more conveniently, the main decisions can easily be fudged or postponed.

Thus the Bush administration is still trying to push for Ukraine to be given a clear path towards future NATO membership. It reiterated this at a recent high-level NATO-Ukraine meeting in Estonia. But if Mr Obama wants to cash in his popularity in Europe, he is more likely to do so by asking European countries to send more troops to Afghanistan, not to swallow their objections to NATO membership for two increasingly unconvincing candidates: a chaotically divided Ukraine and an erratic, indefensible Georgia.

An Obama administration may concentrate on the nitty-gritty of military reform in the Ukraine rather than grand promises of NATO membership. That would be welcome in Russia. So too might be Mr Obama’s rather more doveish line on nuclear weapons (see article). But another sore point with the Kremlin is America’s plans for missile defences, and especially for the siting of ten interceptor rockets in Poland and a radar in the Czech Republic. These—if they work—might stop or deter an Iranian missile attack on America or Europe. But public opinion in the Czech Republic and Poland remains unenthusiastic. And Russia has now threatened a bunch of countermeasures, including putting nuclear-capable missiles in the Kaliningrad exclave and targeting the missile-defence installations with its own nuclear arsenal.

Mr Obama, like many Democrats, sounds sceptical on missile defence. With no money allocated to the programme by Congress, it will be easy to keep the plans alive on paper, but to do little to promote them in practice. And if talks with Russia about nuclear weapons do go ahead, a deal on missile defence might be thrown in. Czechs and Poles may feel a touch queasy as these issues are discussed over their heads; but there is little they can do about it in practice.

Nor is it likely that an Obama administration will fight hard for greater European independence from Russia’s monopoly of east-west gas pipelines. The Bush administration promoted Nabucco, a pipeline that would bring Caspian and Central Asian gas to Europe via Turkey. But a shambolic and inattentive European policy on pipelines and energy dependence in recent years has left policymakers in Washington feeling that they are wasting their time. If the Europeans cannot look after their own interests, why should America?

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Tuna in the Mediterranean

Gone fishing

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The European Commission is accused of withholding embarrassing data

ON NOVEMBER 17th an international meeting in Morocco will consider how much bluefin tuna should be caught in the Atlantic and Mediterranean next year. But it may lack crucial data. The group, called the International Commission for the Conservation of Atlantic Tunas (ICCAT), meets every year to argue over quotas, of which the European Union's is the biggest. The EU divides this among its members in December (when the big row will be about plans to slash cod quotas).

The population of bluefin tuna is crashing after decades of overfishing, mainly by Europeans. This year a European body, the Community Fisheries Control Agency (CFCA), has gathered data on bluefin and conducted inspections. Green members of the European Parliament asked for the study in September. But nothing materialised until Philippe Morillon, the French chairman of the parliament's fisheries committee, got the CFCA to produce a ten-page summary on November 6th. It concludes that "it has not been a priority of most operators in the fishery to comply with ICCAT legal requirements". Rules on reporting catches and banning spotter planes have been flouted too.

Yet Raül Romeva, a green MEP from Spain, says this summary is a "sanitised" version. He believes the full report has been suppressed by the commission at the request of national governments because its contents are so embarrassing. The full report is said to contain details about the scale of infringements, including which countries are responsible. One-third of inspections, says Mr Romeva, led to an apparent infringement, such as inadequate catch documentation. The commission, he says, is covering this up.

Mielgo Bregazzi, a fisheries consultant, says he saw a copy of the full report in August, just before it went to the commission. He confirms that it contains the detailed data that the greens and the fisheries committee have been asking for. If the report does not materialise before November 17th, the ICCAT meeting will not have the full picture at a critical moment. In a letter to delegates, Fábio Hazin, ICCAT's chairman, says this is its "last chance to prove we can do our job properly. If we fail, other institutions will take over."

Mr Hazin is reluctant to spell out what this means. But a spokesman for the UN agency that regulates trade in endangered species, CITES, confirms that "some countries" want to put bluefin tuna forward for CITES protection if the results of the ICCAT meeting are unsatisfactory. This would make the politics of bluefin even more fraught, as the Americans believe that for many years the bluefin population in the Atlantic has been consistently overfished by Europeans.

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Moldova and Transdniestria

Another forgotten conflict

Nov 13th 2008 | CHISINAU AND TIRASPOL
From The Economist print edition

Good behaviour in Moldova's separatist dispute reaps meagre rewards

"LET us live in poverty, but in a country at peace," says Vasily Sova, Moldova's negotiator with its breakaway territory of Transdniestria, when asked about the billions lavished on Georgia after its August war with Russia. Unlike the belligerent Georgia, Moldova has taken a gentle approach to its Russian-backed separatists, and it is not trying to join NATO. Yet it is barely nearer than Georgia to a deal over lost territory.

Russia's prime minister, Vladimir Putin, went to Moldova this week to push a new initiative. Russia does not recognise Transdniestria's independence, but it wants to keep troops there, a condition all other parties reject. The Moldovan and Transdniestrian leaders have not met recently. Moldova's president, Vladimir Voronin, was turned back when he tried to visit his home village in Transdniestria. Mr Voronin called Transdniestria's leader, Igor Smirnov, "an evil force who has turned his region into a festering wound on the body of Moldova".

Yet the dispute has none of the deep hostilities of the Caucasus. Trade across the Dniester is flourishing. The Transdniestrian football team, Sheriff, tops the Moldovan league. Tiraspol is something of a museum of Soviet nostalgia, with its Lenin statue and Karl Marx street. But Sergei Cheban, head of the foreign-affairs committee in the Transdniestrian parliament, tries to be reasonable. Of Russia's recognition of Abkhazia and South Ossetia, he says "we do not need that kind of recognition," holding out the chance of a sovereignty deal with Moldova.

The European Union, just 100km (60 miles) away, has both carrots and sticks at its disposal. The promise of trade with the EU has enticed some 500 Transdniestrian companies to register in Moldova's capital, Chisinau. Against that, Europe's border assistance mission to Moldova and Ukraine (EUBAM), based in Odessa, is trying hard to prevent smuggling in the area. Data turned up by EUBAM suggests that most rumours of arms- and drug-smuggling are mythical. But there is a lively and lucrative, if more banal, trade in which Ukrainian and Moldovan businessmen exploit the black hole of Transdniestria to dodge customs duties on cars or chicken. In 2006, EUBAM has found, the poor folk of Transdniestria nominally ate 12 times as much chicken per head as Germans.

A settlement of the Transdniestrian dispute would nudge both Moldova and Ukraine closer to Europe. It could also win Russia a friendly outpost on the edge of the EU. Yet Russian stubbornness has been matched only by European indifference. If both sides want a more constructive relationship, as the EU's decision this week to restart partnership talks with Russia suggests, Transdniestria might be a good place to begin.

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Charlemagne

No room in the ark

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From The Economist print edition

The euro may not be quite as safe a haven as enthusiasts are claiming

Illustration by Peter Schrank

FOR those fond of gloating, the story of Noah's ark is an unsatisfactory read. As the waters rise, no mention is made of sinners thumping on the ark's closed doors, pleading to board. Nor during the flood itself do we see Noah cruising past small boats, filled with once-proud folk who thought they could go it alone. Happily, fans of smugness have been given a second chance by today's financial crisis, and specifically by much coverage of Europe's single currency, which has depicted the euro as an unsinkable safe haven for the 15 countries that use it.

Editorials with such headlines as "L'euro protecteur" have appeared in big continental newspapers, arguing that "the evidence is irrefutable: the costs of staying out of the euro are high." Commentators have pointed at European countries like Hungary, Iceland and Denmark that are not in the euro, and whose national currencies have come under attack. Such countries now have "only one dream", it is suggested: to get into the euro and shelter from the storm. The boldest even predict that Eurosceptic Britain will end up joining the euro, perhaps in return for a European Union rescue of its banks. Boosters of euro-area enlargement have also called for the rules on admission to be loosened, so that countries can climb aboard the euro-ark sooner.

In Britain Eurosceptics take an alternative view (tinged with their own variety of smugness). They have been dusting off old headlines about the break-up of the single currency, after the gap widened dramatically in recent weeks between Germany's bond yields and those that Italy and Greece were offering on government debt. The market seems to be saying that Italy and Greece cannot be trusted to share a currency with Germany, these sceptical commentators concluded: they will either default on their debts or crash out of the single currency or (most likely) both.

In truth, the gloating is not justified on either side. Euro membership is certainly not a panacea. It can store up trouble by reducing pressure for structural reforms, says Simon Tilford of the Centre for European Reform, a London-based think-tank. For example: thanks to low euro interest rates, Italy can service its debts more cheaply. But without the option of devaluing its own currency, its competitive weakness is being cruelly exposed.

For countries that are catching up fast with richer neighbours, euro membership can bring interest rates that are low or even negative in real terms, fuelling credit booms. This happened in Spain and Ireland, says Jean Pisani-Ferry of Bruegel, a Brussels think-tank. The same would apply in Bulgaria now if it were

to join the euro (as it is keen to do). Domestic policies matter, whether you are in or out of the single currency, he says. So does a country's level of development.

Yet if they are honest, Eurosceptics should also admit that their case has taken some knocks lately. They spent years praising little Iceland for its Viking-raider approach to international business and its refusal to join the EU. Opinion polls now show that a majority of Icelanders would like to join the EU, which is no surprise. And membership of the euro does seem to have protected small, open economies with big banking sectors, such as Belgium, Luxembourg and Ireland, from potential runs on their currency—a lesson that outsiders are not being slow to draw.

The euro area has eliminated currency crises within its borders, says Joaquín Almunia, the economics commissioner. Being the world's second currency brings added clout just now. But Europeans have also learned that there is no such thing as a "decoupling" from a crisis that began in America, so a single currency cannot, on its own, protect Europeans from external shocks. The euro will not rescue members from a crisis that combines problems in the financial system with a nasty recession, "a mix that we have never tackled in our lifetimes," notes Mr Almunia.

The spreads between euro-area bond yields were "worrying" when they kept growing day after day, the commissioner admits. But now the gaps have stabilised. In his view, they could even become positive phenomena, as the markets start sending useful signals to uncompetitive or profligate countries. A year ago the markets simply did not pay close attention to such things, he argues. Now they are warier of risk and hunting for assets that can be turned into cash without the danger of suddenly losing value.

Let some in, maybe

Nor is there going to be any sudden enlargement of the euro area. The European Commission has been inundated with calls to ease requirements for euro entry but will not consider this. Denmark may be a special case. Its decision to stick with a krone pegged tightly to the euro has left it with a purely notional form of independence. Now the global downturn and speculative attacks have forced Denmark to raise interest rates way above euro-area rates. It is "illogical" to remain outside, admits a senior Danish official. The government is trying to win over a sceptical left-wing party to the cause; it could hold a referendum on the euro next year, with a view to joining as soon as 2010.

In contrast, Icelandic ministers visiting Brussels have been told, firmly, that euro membership cannot happen unless they join the EU first, a process that would take some years. Beyond that, governments within the euro area are now warier of enlargement. If Hungary and Poland want to join, "we must stick to the treaties," says one senior national official. That requires applicants to meet all the Maastricht criteria, including two years of close alignment against the euro.

The euro's defenders are convinced that the currency will still be there at the end of the crisis. That is a reasonable bet. But public support for the euro may still be painfully tested as economies deteriorate. Over-high expectations cannot help. Calling the euro a haven from the storm is not just economic nonsense. It is political bad sense, since nobody is going to be sheltered from this deluge. Voters need to understand that, now.

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Politics and the recession

Bigger, wider, deeper

Nov 13th 2008
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Tax cuts make a cross-party comeback, thanks to economic woes

Illustration by David Simonds

HOUSES, financial services, iPods—all sold well during the decade and a half of economic growth that preceded Britain's incipient recession. One thing there wasn't a market for was tax cuts. Labour increased the tax burden to splurge on public services. Far from feeling put-upon, voters spurned offers of lower taxes from the Conservatives at consecutive elections. And the Liberal Democrats saw their vote go steadily up between 1997 and 2005 as they made the case for higher taxes.

Yet such are the political changes being wrought by the downturn—the most profound of which remains the revival of Gordon Brown's premiership—that soon all three parties could be standing on tax-cutting platforms. The pragmatic need to stimulate a flagging economy has achieved what years of principled arguments for lower taxes failed to do.

At a G20 meeting in Washington on November 15th, Mr Brown is expected to seek agreement from other leaders on the need for an international round of tax cuts. This would set the scene for the pre-budget report (PBR) on November 24th, which will reveal details of the government's plans to lower taxes and borrow more to pay for it. These could include bigger tax credits and more help for losers from the abolition of the 10% income-tax rate. Bringing forward spending is also likely to feature.

The Conservatives' plans, announced on November 11th by David Cameron, their leader, eschew any tax cuts that are not matched by cost savings. Their latest wheeze is to give firms hiring workers who have been unemployed for at least three months relief from their national insurance (NI) contributions, paid for by some of the cash saved on jobless benefits. This comes on top of existing pledges to lighten sales taxes and NI for small firms as well as freeze some council-tax rates for two years.

But it is the Liberal Democrats who have gone the furthest, and the earliest. At the party's recent conference an existing pledge to cut the basic rate of income tax by four pence in the pound (paid for by green taxes and closing loopholes) was extended by Nick Clegg, their leader. He wants to make savings in public spending and use some of it to cut taxes further.

However much it jars with the recent history of the tax debate in Britain, the emergence of a consensus for tax cuts was becoming inevitable. Bad economic news abounds: figures released on November 12th showed unemployment at 1.8m—a quarterly rise of 140,000 and the highest since 1997. Comparable

economies, such as Germany and America, are planning tax cuts of their own. The monetary lever cannot be pulled much more furiously than it has been (the Bank of England slashed the base rate of interest by one and a half percentage points on November 6th and will probably cut more) but banks' unwillingness to lend has gummed up the transmission of lower rates to borrowers. Experts have given fiscal stimulus the nod, including Mervyn King, the bank's governor, who offered qualified support this week.

But underlying the consensus on the need to cut taxes is profound disagreement on just how it should be done. Both opposition parties worry that extra borrowing could threaten an economic recovery by pushing up long-term interest rates and requiring sharp tax rises in later years. Mr Brown retorts that a funded tax cut is not a stimulus, and that his efforts to pay down the public debt while he was at the Treasury mean that Britain can safely borrow.

If Labour is alone among the political parties in how it proposes to pay for a tax cut, the Tories may end up equally isolated on the question of whom the cuts should be aimed at. The Lib Dems' ideas, as well as those favoured by the government, are designed to stimulate demand by boosting incomes that have been squeezed recently. The Tories' focus is on staving off job losses by easing the cashflow of employers.

The impact of the government's plan on the economy will take time to gauge, and, if the recession is over by the time the next election is called (which cannot be later than June 2010), the Tories' ideas may never be tested. Yet the political winners and losers may emerge more quickly.

For Mr Brown, a successful G20 and PBR would accelerate the momentum he has gained from his handling of the economic crisis and Labour's surprisingly comfortable by-election victory in Glenrothes on November 6th. But his rhetoric has raised the stakes. As he has promised to be radical in boosting demand, anything less than a big tax cut may fall flat. Already the government has had to cool speculation that a £15 billion ($23 billion) cut is in the pipeline, after Robert Chote, director of the Institute for Fiscal Studies, a think-tank, said such a sum might be required.

The Tories are also poised precariously. If their targeted and funded tax cuts prove wiser in the long-term than more eye-catching alternatives, it may transform the current reputation of George Osborne as a shadow chancellor given more to political tactics than to economic strategy. But with Labour doing less badly in the polls, the Tories may not be able to spurn chances for short-term glory. Business is hardly ablaze with enthusiasm for their NI proposal, and much of the party longs for bigger cuts.

What makes the emerging battle all the more gripping is that the protagonists are defending positions contrary to their recent instincts. Mr Brown, whose self-styled prudence led him to deplore Tory tax-cut pledges for a decade, boasts about taking Britain deeper into the red to leaven a recession. The Tories, natural tax-cutters, are now the chastening voice of fiscal rectitude—to the bafflement of many. And the Lib Dems, with their left-wing base, are promising some of the biggest direct tax cuts since Margaret Thatcher. Recessions make politicians do funny things.

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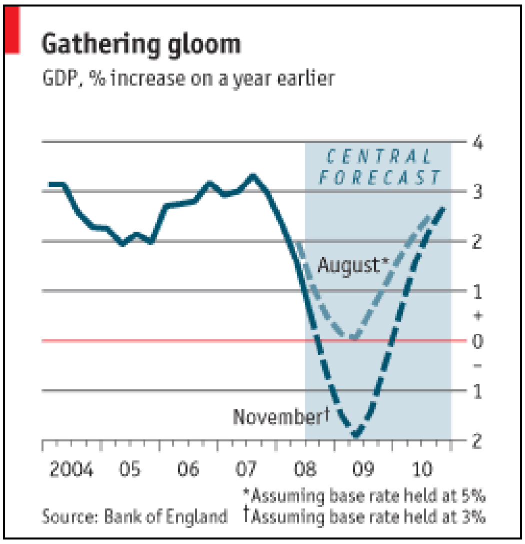
Interest-rates outlook

Plumbing new depths

Nov 13th 2008
From The Economist print edition

The Bank of England signals more cuts to come

THAT show-stopping cut in interest rates looked like a hard act to follow. But on November 12th Britain's central bank rose to the occasion as it unveiled the dire forecasts that had prompted its decision a week earlier to cut the base rate from 4.5% to 3%.



Even after its hefty monetary easing, the Bank of England now expects a nasty recession. Its central projection, set out in the quarterly *Inflation Report*, shows GDP falling by almost 2% in the year to the second quarter of 2009 (see chart). This outcome is far worse than the bank envisaged in August, even though its forecast then seemed fairly gloomy.

The Bank of England has also slashed its inflation forecast as a result of both the severe recession and the oil-price bust. It now expects consumer-price inflation, currently 5.2%, to fall below 2% in the second half of 2009 and to less than 1% during the course of 2010. That would land the central bank in trouble for undershooting rather than overshooting the 2% target. Indeed, the broader retail-price index, which will pick up the effect of lower mortgage-interest payments, will probably record deflation next year.

The message for the City, where traders marked down the pound to a close of $1.50, was clear. If consumer-price inflation is about to plummet so far below its target, more rate cuts will be coming soon. Simon Hayes, an economist at Barclays Capital, an investment bank, says he now expects the base rate to fall a full percentage point to 2% in December and then still further, to 1.5% in January and 1% in February.

The precise extent of the rate cuts will depend in part on the size of the government's budgetary boost, which the chancellor will reveal on November 24th. Mervyn King, the Bank of England's governor, said on November 12th that he supported some fiscal stimulus, provided it was temporary and accompanied by a medium-term plan to get the public finances back on to a sustainable footing.

But even with some budgetary help and further monetary easing, tough times clearly lie ahead over the next year or so. What's more, the central bank may be too optimistic in the recovery it portrays after that. Its forecasts imply that GDP will grow by around 1.7% in 2010 following a decline of 1.3% in 2009.

That upswing is supposed to come as domestic demand picks up, thanks to lower interest rates and improvements in credit availability and real take-home pay, while exports benefit from a lower pound. But heavily indebted consumers will want to mend their own finances by saving more, not least in a climate of job losses. Exporters may be more competitive but they will be held back by the global downturn. International evidence from previous banking and housing crises suggests that economies do not bounce back from them in a hurry.

Mr King insisted that the central bank's extraordinary cut in the base rate reflected the exceptional nature of the banking crisis in September and October. Unfortunately, the exceptional genesis of the recession suggests that it may turn out to be even deeper and longer than the Bank of England now fears.

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Renewable energy

The green pound

Nov 13th 2008
From The Economist print edition

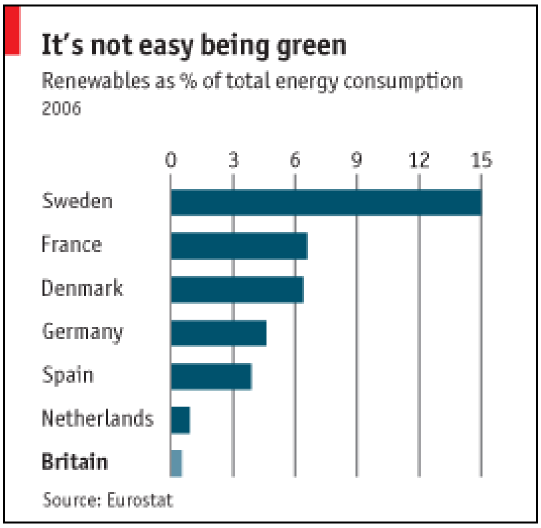
Greenery may create jobs—but not the ones its boosters think

IT HAS been a confusing time for Britain's environmentalists. Dismay greeted reports on November 6th that BP, an oil firm, was ditching plans to build a wind farm at the Isle of Grain, a blowy expanse of industrialised desolation in Kent. In fact, said BP, it was pulling out of wind energy in Britain altogether in favour of an American market brimming with $15 billion (£10 billion) a year in green-power subsidies. Four days later moods lifted when Vattenfall, a Swedish company, said it was joining forces with Scottish Power to build a 300MW, £780m wind farm off Kent.

Britain is keen on windmills for two reasons. First, it has promised big reductions in carbon emissions (an 80% drop by 2050 compared with 1990) and a barely credible boost in the amount of energy it gets from renewable sources (15% by 2020). And second, ministers see green power as a growth industry. Gordon Brown said in June, for example, that renewable energy could provide 160,000 new jobs. The prime minister compared its potential with the explosive growth in the 1970s and 1980s of the offshore oil industry.

In many ways, Britain seems an attractive destination for green investors. The country is one of the windiest and most wave-battered in Europe. Liberalised markets mean few barriers to entry. After 15 years of dithering, says Mark Woodall, the boss of Climate Change Capital, an investment bank that advises Vattenfall, the government's green targets suggest that it is at last taking renewable energy—particularly offshore wind power—seriously. And with an electricity-generation crunch looming as old nuclear power stations and dirty coal plants close, there is a great appetite for new power stations of all kinds.

Despite these advantages, a clunky subsidy regime and planning delays have conspired to slow investment and keep Britain near the bottom of the European renewables league (see chart). Both are being reformed, with extra cash for expensive technologies and powers to overrule local planning objections. Even so, Mr Brown's comparison with North Sea oil highlights risks as well as rewards. In the 1960s it was hoped that the development of oil and gas would revive British manufacturing with orders for drilling rigs, production platforms and survey vessels. In the event, much of the equipment was brought in from America or Norway.



Something similar is happening with windmills. A report published by the British Wind Energy Association (BWEA) concludes that the manufacture of wind turbines—one of Europe's fastest-growing industries—has already been cornered by Germany, Spain and Denmark, which have created 133,000 jobs among them. "We've missed a trick with onshore wind," admits Gordon Edge, the BWEA's chief economist. There is more hope for offshore wind, which is technically trickier, since North Sea oil has left a legacy of marine-engineering expertise in Britain. But the Danes—who built a big offshore wind farm in 2002—have a head start.

Tidal and wave energy could offer a second chance. The European marine-energy research centre is located in the Orkney Islands, and plenty of research and development work is being done around the country. But marine energy will not be competitive with wind for many years, and it is hard to see why, having missed the opportunity to build wind turbines, Britain's factory-owners will be more adroit when it comes to ocean power. "Sometimes you do despair a bit of British manufacturing," says Mr Edge.

Happily, the service sector is more adventurous. Even as the Danes, Spanish and Germans were cornering

the market in turbines, the City of London was developing green-energy services. It now hosts the world's biggest carbon-trading exchange and has a profitable line in renewable-energy finance. Greenery may indeed create new jobs, but chances are that they will not be the ones Mr Brown has in mind.

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Child-killing

Most foul

Nov 13th 2008
From The Economist print edition

The wrong lessons learnt, and another horrifying death

ON NOVEMBER 11th two men were found guilty at the Old Bailey of killing a 17-month-old boy known to the public only as Baby P. The toddler had a broken back, eight fractured ribs, a missing fingernail and toenail, multiple bruises and an ear almost torn off. What finally killed him on August 3rd 2007 was a blow to the head so severe that the postmortem found a tooth in his stomach.

The two men, one the mother's boyfriend, the other a lodger, were found not guilty of murder. They will be sentenced on December 15th for "causing or allowing the death of a child", an offence that was placed on the statute books in 2005 to stop those jointly culpable for a child's death from avoiding punishment by blaming each other. Earlier, the baby's mother had pleaded guilty to the same charge. The maximum sentence is 14 years.

Such horrors were supposed never to happen again, after a shake-up of child protection following the murder of eight-year-old Victoria Climbié in 2000 by her guardians. Yet they did happen again, and in almost the same place. Baby P had been on the "at risk" register in Haringey, north London, since he landed in hospital with head injuries nine months before his death. Victoria had also been seen repeatedly by Haringey social workers, who had missed many chances to save her life.

A review of the government's child services by Lord Laming after the Climbié case, published in 2003, placed some blame on the staff who had missed evidence of her abuse but more on failures of communication. Social, criminal and medical agencies did not know that she was an object of concern to them all. Lord Laming recommended that local children's services be integrated and a national child database be set up. The government accepted both proposals: never again would a child slip between the inter-agency cracks.

At least, that was the idea. But Baby P was well known to the social services, and the summary of the internal review by Haringey itself, handed to the government this week, found "clear evidence of appropriate communication between and within agencies". There was, however, plenty of evidence of individual incompetence. Two days before Baby P's death a paediatrician failed to diagnose his broken back and fractured ribs, saying he was too "cranky" to be properly examined. Days earlier, a social worker had visited and found him smeared with chocolate and antiseptic cream, which covered the worst marks on his body. She fell for a tale of a skin infection and a recently eaten biscuit.

The case of Baby P shows that the belief that integrated services can make up for individual deficiencies is mistaken. It also calls into question the post-Climbié emphasis on data sharing. Everyone who saw Baby P was aware of the initial, incorrect assessment by social workers that his family was chaotic but loving, and no one realised the two guilty men had moved into the home. "New incidents were interpreted in terms of the existing understandings of the family dynamics," said Haringey's review. The government has ordered an independent review into child services in Haringey, and asked Lord Laming to look at child protection across Britain again.

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Scottish politics

The union forever?

Nov 13th 2008 | EDINBURGH
From The Economist print edition

Recession is cutting into the nationalists' popularity

PA

ONE of Alex Salmond's proudest boasts from his first year as nationalist first minister of the devolved Scottish government was persuading local councils to freeze their tax levels. He achieved it by giving them a generous 5% spending increase for the fiscal year to March 2009 and much more freedom in how they spent it. But now inflation and recession are biting chunky holes in council budgets, cuts are having to be made and a lot of the election pledges of the Scottish National Party (SNP) are being binned. Mr Salmond's seemingly unassailable post-election popularity has suddenly plunged as a result.

The blows to the councils' finances are big. Edinburgh thinks it will make only £23m from selling surplus land and property this year, rather than the £43m it expected. Extra fuel and energy costs will add £10m to its bills. Glasgow council says that the tanking property market will reduce its revenue from planning applications by about £1m a month. Fewer new homes also mean that council-tax receipts will be down by about £1.4m on the year. Councillors across Scotland are in a similar plight, and so are having to cut spending.

The electoral consequences were all too obvious in the Glenrothes parliamentary by-election on November 6th. The SNP had hoped that anger over rising energy bills and gratitude for the council-tax freeze would bring it victory over Labour, as they helped to do in Glasgow East in July. Instead, voters were furious that SNP-controlled Fife Council wanted to hike home-help charges for the elderly. Remarkably for a mid-term election during an economic crisis, governing Labour's share of the vote went up by three percentage points, and it held the seat with a comfortable 6,737-vote majority over the SNP.

To his credit, Mr Salmond took the blame for the defeat, saying that he had incorrectly judged the electorate's mood and failed to counter Labour's "negative" campaigning. The rebuff may explain why he has been curiously subdued about the big independence battle that is now dominating Scottish headlines—stopping the takeover of stricken HBOS, headquartered in Edinburgh, by Lloyds TSB.

Sir Peter Burt, the Bank of Scotland boss who engineered its merger with the Halifax Building Society in 2001, and Sir George Mathewson, a former chief executive and chairman of Royal Bank of Scotland, are now campaigning to persuade shareholders to oust HBOS's current top management and install them instead. They argue that shareholders will get better returns if HBOS stays independent, and that the prospect for Scottish jobs and prosperity will be rosier too.

Shareholders have been cool towards the banking knights' initiative. Mr Salmond too has been cautious, saying merely that the two men deserved "great respect". But he has returned to form with the release this week of the British government's submission to a commission under Sir Kenneth Calman set up by Scotland's main political parties to review devolution.

Many Scots think their devolved government needs more powers, especially on the fiscal side. Earlier this year Gordon Brown raised hopes that he was ready to cede some tax-raising powers in order to improve accountability. But the government submission made no such suggestions and even hinted that it would like to take back some powers—for example, over the siting of new nuclear-power stations.

The government, roared Mr Salmond, is making a big mistake in "rejecting majority Scottish opinion" and trying to stop the momentum of Scottish self-government. As the next general election draws near, this will become a much bigger debate. Any hint from Labour that Scotland is incapable of looking after itself will irk Scots and delight the SNP. From the jaws of victory in Glenrothes, Mr Brown seems to be preparing

to snatch defeat.

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Airdrie Savings Bank

Boring, stolid, small and safe

Nov 13th 2008 | AIRDRIE, LANARKSHIRE
From The Economist print edition

How one bank stuck to its last and prospered

AMID the hallucinogenic chaos of world finance today, it would be hard to find a duller bank than Airdrie, the only surviving, and currently thriving, independent savings bank in Britain. Customers love it. “We had an inflow of £8.5m in deposits in October,” says Jim Lindsay, the bank’s general manager.

Airdrie Savings Bank

Safer than houses

That may not sound much, but it represents a 7.4% increase in deposits. Airdrie Savings Bank is tiny. It has seven branches, 60,000 customers and 104 employees to serve the county of Lanarkshire, east of Glasgow. It was born out of the savings-bank movement pioneered in 19th-century Scotland by the Rev Henry Duncan, concerned that his poor parishioners had nowhere to save money earned in good times to draw on in tough times later. Mr Duncan’s success rapidly spawned copies throughout Britain and, eventually, in America. In 1985 the little bank sturdily resisted heavy pressure from the Bank of England and the Treasury to join the amalgamation of most other such banks into the publicly quoted Trustee Savings Bank (TSB), which was later privatised and bought by Lloyds in 1995.

The headquarters, an elegant but austere Art Deco building across the road from Airdrie’s police headquarters, speaks of security. Inside, tellers under the portraits of bewhiskered Victorian forebears have modern computers but do old-fashioned things, such as weighing bags of coins; they do not sell customers insurance or mortgages.

Ten self-selecting local businessmen and professionals act as trustees, forming the board which Mr Lindsay reports to but does not sit on. They stick stodgily to a rule that only a third of customers’ deposits (which totalled £115m in 2007) should be advanced in loans, a third kept on deposit with other British banks for liquidity purposes and a third invested in government bonds. Profits, limited to between £500,000 and £750,000 a year, are made only to bolster the bank’s reserves, £14m last year. There are no shareholders: Airdrie Savings Bank’s customers own it. The reserves, bonds, and deposits it keeps with other banks are its core capital, which amounts at present to about 30% of its liabilities, says Mr Lindsay. That is more than three times the increased capital demanded of British banks since the recent bail-out. A modest across-the-board bonus is paid to all staff when conditions merit it.

“Risk” seems almost a swear word at Airdrie. The bank does not issue credit cards, only debit cards. “We don’t have any currency risk,” says Mr Lindsay. And he arches his eyebrows at the folly of the Barnsley Building Society, which rushed into a merger with the Yorkshire Building Society last month after discovering that £10m of its assets were locked up in tottering Icelandic banks. Airdrie’s bad debts in 2007 were just £53,000, against loans of £33.5m, four-fifths of them to local businesses. “We’d only be in trouble if the whole British banking system collapsed,” says Mr Lindsay. “But then, everyone would have a lot more to worry about than us.”

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Cash and local councils

Icelandic saga

Nov 13th 2008
From The Economist print edition

Were they reckless, badly advised or just unlucky?

Illustration by David Simonds

BACK in 1991 scores of local authorities used newfangled financial swaps to bet and lose millions on interest rates. They were let off the hook by the House of Lords: the peers ruled the deals null and void because council officers had been acting beyond their legal powers.

No such defence can be used this time. Local governments—123 of them—stuffed £919.6m into accounts with Icelandic banks that paid over-the-odds interest rates until they collapsed and were nationalised in October, with deposits frozen. On November 13th council representatives were in Iceland to treat with Deloitte & Touche, the accounting firm handling the bank work-out there. They have little chance of being repaid in full.

Why were so many councils caught when there were signs up to two years earlier that Iceland's three banks—Landsbanki, Kaupthing and Glitnir—were shaky? The Icelandic banks were offering the best deposit rates going: that in itself should have made the councils wary. Credit-default swap (CDS) rates for the three banks—one measure of their riskiness—began to rise in July 2007 and hit a peak in April 2008. Alarm bells rang for the few council finance chiefs whose advisers warned them.

But many councils, and their advisers, relied slavishly on the assessments provided by two debt-rating agencies, Fitch and Moody's. Apart from one adjustment by Fitch on May 9th, the agencies gave little warning that any of the banks was truly likely to fail until September 30th. Too late to save the London borough of Haringey, for instance, which had made deposits with Landsbanki and its British subsidiary, Heritable Bank, just the day before.

Retail depositors, for whom the British government is organising full repayment whether or not Iceland pays out, could not have been expected to monitor banks like professionals, the argument goes. But councils, often with several hundred million pounds of cash to deposit, have strict prudential guidelines. They are encouraged to seek the highest rate of return "consistent with security and liquidity". Security, however, does not mean just watching credit ratings—and if councils did not appreciate this, their advisers should have.

Local authorities use three financial firms for professional advice: Arlingclose, Butlers and Sector Treasury Services. Arlingclose, a newcomer, started warning its clients against the Icelandic banks in 2006, with increasing stridency as the CDS rates rose. All 45 of its clients heeded its advice, although three, recently acquired, had Icelandic deposits already. Butlers, many of whose clients were placing deposits just days before the banks were nationalised, insists that it relays rating changes to its clients but does not give

credit advice. (Ipswich borough council, however, says that Butlers advised it on May 12th to cease investing in Kaupthing Singer & Friedlander, and on August 15th to avoid Glitnir.) Butlers boasts on its website that as part of ICAP, the world's largest money and securities broker, it has "first-hand information on the institutions that are active in the sterling market". That apparently did not include relaying intelligence on CDS rates.

Sector too insists that it does not make recommendations to clients concerning credit quality, but only gives them strategic financial advice. Yet Mid-Devon district council says it acted in April on telephone advice from Sector to reduce its exposure to Icelandic banks. That did not, however, discourage it from investing £1.1m in Heritable Bank as late as September 15th.

Many chastened councils are now putting their deposits with the Treasury's Debt Management Office. Strategies are being rethought. One weakness was a blind faith in credit ratings; another was local authorities' reliance on just two or three advisers. Together, these were a formula for herd behaviour, and sloppy behaviour at that.

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Bagehot

The twilight zone

Nov 13th 2008
From The Economist print edition

Everything suddenly seems possible in British politics

Illustration by Steve O'Brien

FOR the plotters of coups, timing is all. Move too early, and they find themselves facing a firing squad, fleeing into exile or, in more sedate countries, being snubbed in the parliamentary tea rooms and excluded from the membership of select committees, with their supposed champion immortalised as the wielder of a banana rather than of power. That is the fate that seems to have befallen the Labour MPs who called for Gordon Brown to step down, just before the global economy imploded and the prime minister was extolled as its stalwart saviour. The plot, if not the plotters, is now dead—right?

There are two things that everyone now knows about British politics. One is that Mr Brown is safe: the rebels have been shamed; the doughty prime minister will lead his party into the next general election. The other is that he and Labour are doomed: their defeat on polling day is still near-certain, even if a narrow one now seems more probable than a rout. Both parts of this new conventional wisdom, Bagehot submits, are doubtful.

Consider the abortive coup of recent but somehow distant memory, an episode now treated by the Labour Party as a regrettable bout of collective hysteria. How different things have since come to look: Labour won an unexpected but handsome victory in the parliamentary by-election in the Scottish constituency of Glenrothes on November 6th; it is still down in the polls, but the deficit is starting to resemble a respectable mid-term gap rather than an unbridgeable chasm. Meanwhile, once-hyped rivals to Mr Brown have slipped into semi-obscurity. David Miliband, the banana-wielding foreign secretary, finds himself remote from the new preoccupation of economic management.

But some things haven't changed. The government is still enervatingly old. Mr Brown is still not charming. His dire lack of some elementary political skills was again exposed during prime minister's questions in the House of Commons on November 12th: David Cameron, the Tory leader, pressed him on the government's response to the shocking killing of a child; Mr Brown unwisely accused his antagonist of exploiting the child's death. And the prime minister has yet to show that he can win any sort of election in England. The gathering recession will soon make lots of people very cross.

Meanwhile, the bad blood that accumulated during Mr Brown's grumpy decade in the Treasury is still

quietly sloshing around his party. If it loses badly in the European elections in June, it is at least conceivable that mutineers will re-surface—decorously portraying Mr Brown as the hero of the credit crunch but the wrong man for its aftermath. His premiership might again come to feel like the "tragedy" once widely advertised, albeit an operatic one in which the hero gets to sing a long climactic aria about reform of the IMF before the curtain falls. Yet at the same time, it has become imaginable that Mr Brown's story will have the opposite ending: that he will not only stay, but win.

Through the looking glass

Some things haven't changed, but some things have, and these may turn out to count for more. Mr Brown now has a less rebarbative press team and a better Number 10 operation. He has Peter Mandelson in his cabinet, whose talismanic importance is plain from the frequency with which the Tories attack him. (So long as he remains in government, Lord Mandelson will also help to cow potential dissidents.) Most important, beneath his uninviting veneer, something about Mr Brown himself is different.

He may not be charming, but at least he seems to mean it when he talks about the state's role as a bulwark against penury during a recession, and when he denounces "laissez-faire dogma". The downturn has let Mr Brown raise what sounds like his authentic political voice, in place of the timid New Labour accent he adopted for much of his career.

Of course, his new mantra—that nationalising banks is laudable boldness; that in providing a fiscal stimulus, "unfunded" tax cuts are the best kind; that borrowing on the never-never is prudent—is a staggering renunciation of New Labour's basic principles. His bid to disavow all responsibility for Britain's economic plight is another brazen intellectual heist. But that may not matter: general elections are mostly referendums on the future rather than the past. Growing numbers of voters seem to be persuaded that this revamped Mr Brown is best qualified to see the country through the doldrums, even if he led it into them.

For their part, the Tories may be overestimating the political importance of blame—and also, perhaps, of the relatively distant future. Their case is that monetary policy offers the most reliable form of stimulus, and that tax cuts financed by borrowing, which may feature in the government's forthcoming pre-budget report, are irresponsibly costly. "Sometimes," Mr Cameron said on November 11th, "these points take time to get through." Quite; but in the interim, his party may find itself in the awkward predicament of criticising a Labour government's tax reductions. "Change" and "responsibility", the abstract nouns that make up his platform, sound oddly oxymoronic. And for all Mr Cameron's own calm plausibility, in the new atmosphere of austerity his front-bench team has come to seem vulnerably jejune. It might not take much—a sleaze scandal, say, or another lavish high-profile holiday—for the shadow cabinet to be seriously discredited.

From the time Tony Blair became Labour's leader in 1994, British politics has had an air of inevitability. That has also been true since Mr Brown took over, albeit in a wildly oscillating way. At first it seemed inevitable that Labour's clunking fist would crush the Tories; then it was Mr Cameron's grip on the polls and policy agenda that seemed ineluctable. He is still likelier to beat Mr Brown than vice versa. But that prediction, indeed all predictions, look less reliable than they have for some time. Politics is entering a twilight zone, where almost everything seems possible.

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Economist.com WORLD INTERNATIONAL

Nuclear disarmament

What to do with a vision of zero

Nov 13th 2008
From The Economist print edition

The tantalising ideal of a world entirely free of nukes is hoving back into view. It's a goal that disciplines minds, even if you never quite attain it

Rex Features

A WORLD without nuclear weapons is a vision as old as the nuclear age. The makers of the bombs that exploded over Hiroshima and Nagasaki in 1945 fretted a lot about the ultimate consequences for mankind of their devilish ingenuity. Now anti-nuclear campaigners are hoping that "Yes, we can!" will do more for their cause than older slogans like "Ban the bomb!" ever did. For on the stump, Barack Obama, America's president-elect, promised to make the goal of eliminating nuclear weapons worldwide a "central element" of America's nuclear policy.

He will not be the first American president to dream of nuclear disarmament; that unlikely peacenik Ronald Reagan did so too in his day, to the consternation of allies at home and abroad. The reality, in any event, is not one that America can will on its own. Yet Mr Obama has tapped into a new seam of dissatisfaction with the world's nuclear order. Might getting to zero soon be a less forlorn prospect?

The latest nuclear-free buzz around the globe takes in more than the usual anti-nuclear suspects. The five officially recognised nuclear powers—America, Russia, Britain, France and China—are all feeling the pressure.

So they should. The Nuclear Non-Proliferation Treaty (NPT) that came into force in 1970 commits them to good-faith negotiations on "effective measures" to end the nuclear-arms race at an early date and to nuclear disarmament as part of a process of "general and complete disarmament under strict and effective international control". That was their part of a bargain that now has 184 other governments signed up not to build bombs of their own. Nuclear numbers have tumbled since the end of the Soviet-American arms race, but they are far from zero.

The nuclear-weapons powers are being pressed to do more ahead of a five-yearly review of the NPT's workings, in 2010. The last such gathering ended in a punch-up. Another ill-tempered diplomatic brawl would further harm the treaty, which is taking a battering all round.

Iran and North Korea, as well as others, have bent or broken its anti-nuclear rules. India, Pakistan and Israel built weapons outside the treaty and reject its constraints. The fear is that, should others follow, the risk of miscalculation between growing numbers of different players will make the era of mutual assured destruction, or MAD—the threat of mutual annihilation that kept a scary peace between America

and the Soviet Union during the cold war—look like a golden age of sanity.

Meanwhile, as more governments from Africa to Latin America look to nuclear power as the answer to meet growing energy demand, potentially dangerous nuclear materials will end up spreading ever more widely. Without stricter controls and tougher inspections, the technologies for enriching uranium and extracting plutonium that can be used to help keep the lights on could also be abused for weapons-making. Moreover, as the barriers to entry in the bomb-making business keep falling, there are fears that terrorists will find it easier to get their hands on a bomb, or other dangerous material.

Despite this, anger that the five still cling to their bombs has made some non-nuclear states dig in their heels against seemingly sensible new ideas, such as an international nuclear-fuel bank that could help stem new proliferation dangers. They see restrictions on their nuclear freedom as another form of nuclear apartheid.

Enter four prominent American elder statesmen, George Shultz, William Perry, Henry Kissinger and Sam Nunn, dubbed the “four horsemen of the apocalypse”. Last year (and again this) they argued in the *Wall Street Journal* for America to take the lead in pushing towards a nuclear-free world. The steps they proposed were not new: further weapons cuts, making safer those that remain, ratifying the Comprehensive Test-Ban Treaty (CTBT), halting production of fissile material for use in weapons and securing all nuclear materials around the globe. Nor, if all were taken, would they get the world to zero. But by holding up a nuclear-free vision, they gave political cover to a renewed debate about whether nuclear weapons, credited with keeping peace between the big powers after the 20th century’s two world wars, are now part of the problem.

Now everybody wants a plan

These days no self-respecting think-tank, it seems, can be without a report on nuclear disarmament. Japan and Australia, sponsors of rival grand commissions when a potential nuclear-free window opened at the cold war’s end, have joined forces to set up a new one.

Yet the document likely to be most thumbed through for clues about the world’s nuclear future will be the American Defence Department’s next nuclear-posture review, due in early 2009. Already the tug-of-war is under way among Mr Obama’s would-be advisers over the principles that should shape it.

In a recent *Foreign Affairs* article, Ivo Daalder and Jan Lodal argued for four urgent steps: a declaration that America’s nuclear weapons have no other purpose than to deter the use of such weapons by others; a unilateral American reduction to no more than 1,000 warheads (including reserves), as a step towards zero; work on an “airtight” verification system; and a vigorous diplomatic effort to convince the world of the logic of nuclear zero.

Parts of this sound more like creed than policy. Some people fear that if you push hard for abolition as an end in itself, the effect could be destabilising in a world that, despite vociferous disarmament demands from Brazil, Egypt, Indonesia, Ireland, South Africa and so on, still relies on America’s extended nuclear umbrella for much of its security. Some suggest using the ultimate goal of total elimination just as a framework for a whole series of steps that could in time ensure greater security, with much reduced nuclear numbers.

There is wide agreement now that convincing others of the five’s commitment to their NPT promises requires movement on several fronts. These include deeper weapons cuts; more effort to bring into force a test ban and negotiate a long-awaited fissile-material cut-off treaty; efforts not only to devalue nuclear weapons as a currency of power and but also to tackle the regional insecurities that drive nuclear competition; and work on globally applicable verification techniques and enforcement mechanisms that would give both nuclear and non-nuclear states the assurance (even long before zero is in sight) that weapons, once dismantled, stay that way, and that cheats can be dealt with.

Of these, cutting weapons numbers is both easiest and symbolically most eye-catching. American and Russian stockpiles are anyway set to drop further. By 2012 they will be down to the 1,700-2,200 deployed warheads apiece agreed six years ago in the Moscow Treaty. America has also been pruning the weapons held in reserve for spares: its nuclear arsenal will by 2012 be less than a quarter its size at the end of the cold war. A cut to a round 1,000 would inconvenience neither side.

But how to go about it? George Bush was hammered for preferring unilateral cuts and so agreed to a

treaty with Russia. Setting 1,000 as a target, give or take weapons in reserve, while offering to negotiate along these lines would reassure all round (as would the binding new verification rules Mr Obama is expected to seek before existing ones run out next year).

Cash-strapped Russia always worries that unilateral American cuts can easily be reversed. But after the Georgia crisis, many of America’s friends would like to see Russia held to tight treaty limits too. Expect anxieties from the Baltic states to Turkey, if Mr Obama acts early on to remove America’s last few tactical nuclear weapons from Europe (where Russia has many more).

Yet the problem for zero-boosters is that the lower you go, the trickier things get, argues Henry Sokolski of the Washington-based Non-proliferation Policy Education Centre. Crises may prove harder to manage when the nuclear gap between America and Russia and other potential contenders is not thousands, but hundreds.

One answer could be to widen arms-control talks to include China, Britain and France too. But neither China nor France has ever signalled interest. And what about India, Pakistan and Israel?

As for more global treaty commitments, Mr Obama is expected to try to get Congress to ratify the test-ban (it refused in 1999). That could prod others, like China, to do likewise. He has also said he will not authorise the building of new nuclear weapons. That is music to disarmers’ ears. But there may eventually have to be a trade-off: ending testing in return for building some simpler, safer warheads (based on a previously tested design).

The upside is that modernisation could enable America to make far deeper cuts than does tinkering with old warheads in today’s stockpile. Anyway, Britain, France, Russia and China are modernising their weapons (only China is enlarging its arsenal, albeit from a low base). The downside is that others will cry foul. The going for a fissile-material cut-off treaty at the log-jammed Conference on Disarmament could be harder still. Long blocked by China, the last try was stymied by Pakistan and Iran. Clever diplomats are paid to find ways round such obstacles—but it will take ingenuity of an untried sort to navigate the minefield between today’s world and one of very low nuclear numbers or none.

One roadblock after another

A recent *Adelphi Paper* from the London-based International Institute for Strategic Studies explores just some of the technical and political obstacles. What would be acceptable standards of verification when controls can never in fact be “airtight” and weapons-making knowledge still has to be protected? What are the trade-offs between imperfect verification and enforcement, since the UN Security Council seems unable to agree on enforcing its resolutions on Iran or North Korea? What might a residual deterrence capability against cheats look like? How might conventional military imbalances be managed in a nuclear-free world, without cascading back towards the carnage that blighted the first half of the 20th century?

The British government has taken a lead, co-operating with the Norwegians to explore techniques for verifying warhead dismantlement without giving nuclear secrets away. But this is the merest tip of the technical work needed to track and secure the world’s dangerous nuclear materials. A British suggestion that the nuclear laboratories of the five might co-operate to find solutions has been handled by the others as gingerly as they might a bomb.

Nuclear weapons will be around for a long time. But thinking zero at least forces governments to see them in a new way.

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A global love affair

Nov 13th 2008
From The Economist print edition

Emerging markets are the car industry's big hope. But it won't be an easy ride, says Matthew Symonds (interviewed here)

AFP

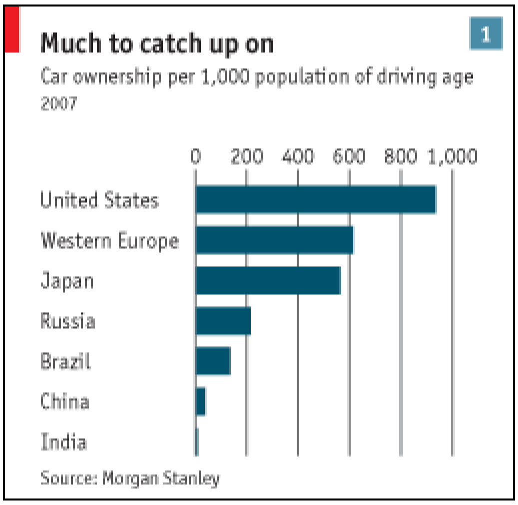
THERE has rarely been a tougher time to be a carmaker. Squeezed by the credit crunch, rocked by the seesawing price of oil and now faced with a nasty recession as the banking crisis infects the real economy, the traditional markets of North America, western Europe and Japan, already sluggish for several years, have all but packed up. In America car sales are running at about 16% below last year's level. Detroit's struggling big three—General Motors, Ford and Chrysler—are in dire straits. They have wrung a $25 billion bail-out from Congress and are now looking for much more. In Europe the market is also collapsing. Sales in Japan this year are expected to be the lowest since 1974.

However, not all is doom and gloom. Mature vehicle markets may be close to saturation, but there is huge unsatisfied demand in the big emerging car markets of Brazil, Russia, India and China (the so-called BRICs). Although not immune from the rich countries' troubles, they are likely to suffer much less. For one thing, levels of personal debt are far lower and a smaller proportion of cars are bought on credit. For another, the BRIC economies have been expanding so fast that even a slowdown should still leave them with growth rates that look respectable to Western eyes.

One measure of the BRIC countries' new importance to the car industry is that, recession or not, global car sales in 2008 may still hit an all-time record of about 59m. For the first time passenger-vehicle sales in the BRICs, at around 14m, are likely to overtake those in America, which are expected to be the worst since 1992. As recently as 2005 America outsold them by over 10m. By the end of this decade China, already the world's second-biggest market, will probably overtake America's sales of 16m-17m in a "normal" year. In Brazil sales have increased by nearly 30% in each of the past two years. Russia is likely to overtake Germany as Europe's biggest market within the next two years, with sales of around 3.5m. Meanwhile, Tata's $2,500 Nano, due to be launched in early 2009, is designed to do for India what the Model T Ford did for America 90 years ago.

It is the irresistible combination of rapid economic growth, favourable demographics and social change in the BRICs that is coming to the carmakers' rescue and that is likely to account for nearly all their growth for the foreseeable future. America has more than 900 cars (including light trucks) for every 1,000 people of driving age. In the big western European countries and Japan, where public transport is better and population is denser, the figure is a little over 600. But in Russia it is below 200, in Brazil about 130, in China around 30 and in India less than ten.

When times are hard, an American family that already has two or three cars will simply postpone buying a new one. But a potential customer in an emerging market who has been saving for years to buy his first car will still want to go ahead. As Carlos Ghosn, the boss of the Renault-Nissan alliance, put it at this year's Beijing motor show: "Nothing can stop the car being the most coveted product that comes with development."



The new champions

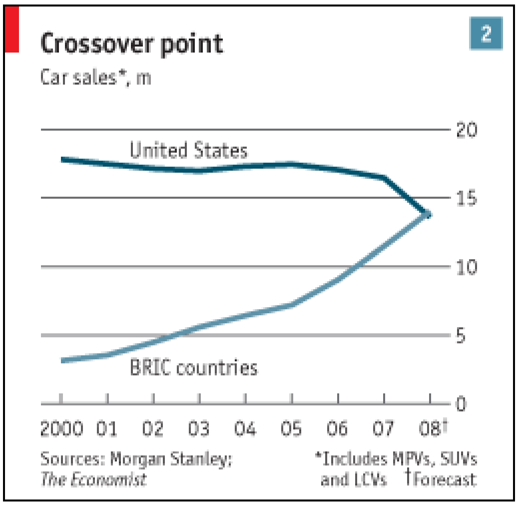
No wonder that all the big carmakers are fighting like rats in a sack to win the largest piece of the action. Already, emerging markets have made the difference between life and death for some of the most famous names in the industry. GM's survival would be in even greater doubt without the meteoric growth it is seeing in China. Thanks in large part to the BRICs, a record 65% of GM's sales in the first quarter were outside America.

When Italy's Fiat was in danger of going out of business a few years ago, its Brazilian operation came to the rescue. Adam Jonas of Morgan Stanley, a bank, estimates that 65% of its net income last year came from emerging markets, mostly from Brazil. Volkswagen, the market leader in China, believes it will soon be able to challenge Toyota as the world's biggest carmaker. In Russia Renault has taken a 25% stake in the country's biggest local carmaker, AvtoVAZ, and its Logan is the first of a new wave of global low-cost cars.

Makes such as Mercedes, BMW and even Bentley and Ferrari are now common sights on the streets of Moscow and Shanghai. As Mr Jonas points out, emerging markets account for more than a third of the world's rich but only about 15% of luxury-car sales.

These markets have much in common, but each is also remarkably different. In China buyers turn up their noses at small cars. The market is still dominated by joint ventures with foreign firms, but the strongest local manufacturers are rapidly expanding production.

Russia still has a sizeable indigenous industry, but many of its products hark back to the old Soviet Union. Like the Chinese, Russians like high and wide SUVs. By contrast Brazilians prefer their cars small. India has established itself as an exponent of what car-industry executives call "frugal engineering"—innovation in the cause of ultra-low cost. Diesel engines are almost unknown in emerging markets other than India because poor-quality diesel fuel is associated with trucks. In Brazil nearly all new cars are able to run on ethanol.



Despite the social and economic benefits that widespread car ownership brings, its spread in developing countries has raised fears about its environmental consequences, especially carbon emissions that have climate-changing effects. Given a rapidly growing world car population and dwindling oil supplies, fuel prices are bound to rise in the long term.

Infrastructure is another big worry. In China new highways are being built on much-needed agricultural land. In India nearly half the traffic runs on just 2% of the country's roads. In the megacities of the developing world, from São Paulo in Brazil to Mumbai in India, cars often move at less than walking speed, stuck in traffic jams.

According to Mr Ghosn, the only way to give people the cars they want without wrecking the planet is to move quickly to producing zero-emission vehicles, probably powered by batteries. "Nothing else will prevent the world from exploding," he says. Others in the industry may quietly agree, but they are less confident that the technology to power them will arrive in time and at an acceptable price. And only governments can build the roads that will accommodate so many more cars. For the world's carmakers the road ahead is full of opportunities, but also many risks.

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Economist.com SPECIAL REPORTS

Theme and variations

Nov 13th 2008
From The Economist print edition

To succeed in emerging markets, rich-country carmakers have to tailor their strategies

THE carmakers that have so far done best from the emerging-market boom are the ones that placed their manufacturing bets early on. That is partly because developing countries have used (and continue to use) high import duties either to protect fledgling indigenous manufacturers or to force global car firms to invest in the development of national motor industries. It is also partly because the car firms have learnt that they have to be on the spot in order to understand local conditions. Each BRIC market is different, and carmakers have had to employ different strategies to succeed in them.

In China, for example, the government has until recently insisted that foreign manufacturers can set up shop in the country only through joint ventures with Chinese partners. It aimed to draw on the financial clout and technical expertise of the world's biggest car companies as a shortcut to creating a Chinese motor industry that was not only capable of meeting home demand but also of becoming a big exporter. The bait to attract foreign carmakers was access to a huge potential market.

The first to bite was Volkswagen (VW), which formed a joint venture with Shanghai Automotive Industry Corporation (SAIC) in 1984. Six years later it established a second partnership with First Automobile Works (FAW), based in the northern province of Jilin. By then the Santana (a version of the Passat) being produced in Shanghai was regarded as genuinely "made in China". By the end of the 1990s VW was selling over 300,000 cars a year in China. VW's share of the market has fallen from a peak of 56% to around 18% today, but its volume has tripled. Despite slowing sales since July the firm still expects to sell more than a million cars in China this year—more than it sells in Germany, and enough to justify its $10 billion investment.

Showing unusual fleetness of foot, GM followed VW into the Chinese market in the mid-1990s by forming a joint venture of its own with SAIC. Like VW, it has prospered by establishing its brands (especially Buick) and its distribution network before other foreign firms rushed into the market, and with a 10% share is now second only to VW. Last year GM sold twice as many Buicks in China as it did in America, where the brand is considered a bit staid.

But the competition is getting more intense. Despite a late start, Toyota, with its main partner, FAW, is threatening to topple GM from its second spot in China and is aiming to produce 1m units by 2010. Another relative latecomer is Nissan. With Dongfeng Motor, it has been producing cars since 2004 from a new integrated factory at Huadu near Guangzhou that can churn out 360,000 a year. This year Nissan added a 6,140-square-metre (69,000-square-foot) training centre for its dealers, a bow to the growing importance of service in a market where consumers have more models to choose from than in America.

In theory foreign carmakers are no longer legally obliged to work through joint ventures in China, but in practice they still do. Adrian Hallmark, VW's head of sales in Asia, explains that a few years ago VW had an opportunity to pull out of one of its joint ventures but decided against it: "When you don't have the cultural and political connections, it is suicidal to go it alone." Over time, he says, VW's partners, SAIC and FAW, are likely to emerge as powerful companies in their own right and will have benefited from the experience of working with VW. He sees no reason why they should want to abandon the joint ventures if they continue to work well for both parties, which he believes they will. Chinese customers, says Mr Hallmark, will always want to buy the best products, so the foreign brands should continue to do well from market growth.

Nick Reilly, the head of GM's Asia-Pacific operations, concedes that joint ventures are never easy to manage and that many fail. "The moment it ceases to be a win-win for both sides, it will go," he says. "Your partner must do well too." GM puts a lot of effort into its relationship with SAIC. Its chief executive, Rick Wagoner, meets up with his Chinese counterparts at least three times a year. Mr Reilly is also philosophical about the inevitable transfer of intellectual property to its partner, saying GM does not want to be "too precious" about it. He concedes that there could be tensions when SAIC's own brands, such as Roewe, start competing directly with GM's, but says that money will still be coming in from royalties and components.

All the foreign carmakers are well aware that the Chinese government is prepared to play a long game. For now and for the foreseeable future the foreigners are part of the plan, but when a handful of potential winners emerge from among the local champions life might well get more complicated. “In the end”, says one senior foreign car executive, “it will come down to politics. It always does here.”

All Brazilians now

There are no such fears in Brazil. The Brazilian market is still dominated by the four firms that have been there longest—GM, Ford, VW and Fiat—and they have always managed without local partners. Last year their combined share of a market of 2.45m light passenger vehicles was 80%.

At Fiat’s Betim factory near the industrial city of Belo Horizonte in Brazil a new car rolls off the production line every 20 seconds. To meet surging domestic demand for new cars, Fiat, the market leader in Brazil, is working Betim flat out, three shifts a day. It is one of the most productive car factories in the world, capable of churning out 800,000 vehicles a year. The biggest concern for Cledorvino Belini, head of Fiat’s operations in Latin America, is that the furious pace of production is putting the complex “just-in-time” logistical system under strain. Cars awaiting transfer fill every corner of the 2.25m-square-metre (24.22m-square-foot) site, and new unloading bays are being constructed at breakneck speed to accommodate the endless flow of trucks delivering the parts.

Churning them out at Betim

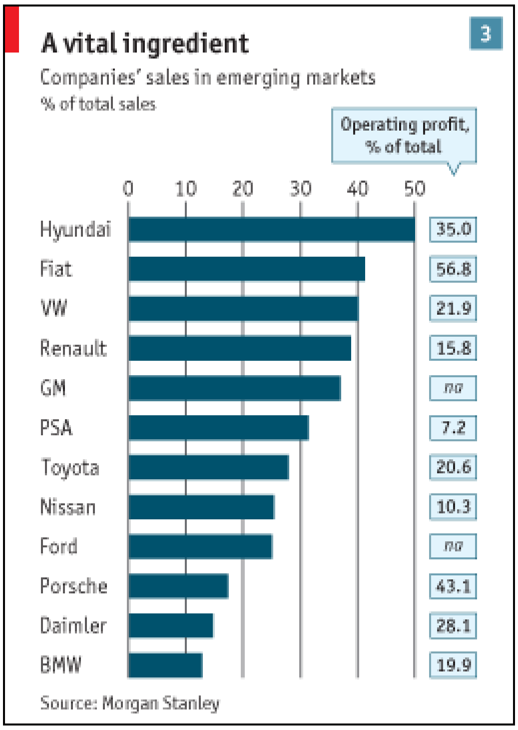
Fiat, which began manufacturing in Brazil 32 years ago, allows its Brazilian arm a lot of autonomy. All its senior managers are Brazilian. They say they want Fiat to be seen as a Brazilian brand—an ambition they back up by sponsoring the shirts of no fewer than ten of Brazil’s best football teams. VW is even more of a veteran, having been in the country for 55 years. Although the top management is mostly German, it claims that Brazilians have strongly identified with the VW brand since the days when the Beetle was the country’s most popular car. More than 3m were produced at the firm’s giant Anchieta factory near São Paulo between 1959 and 1986.

With import taxes still at a swingeing 35% and other car taxes averaging more than 30%, depending on engine size and type, vehicle makers have little choice but to manufacture in Brazil. There was a time when Brazilians could be offered discontinued models from Europe, but apart from the very cheapest cars that is no longer acceptable. Both Fiat and VW now make some of their newest cars in Brazil, including some produced specially for the Brazilian market, such as the Fiat Palio and VW Gol. Both are rugged and small but roomy cars with a range of “flex-fuel” engines that run on any combination of ordinary petrol and cane-based ethanol.

The development of flex-fuel engines is the most striking example of the carmakers’ willingness to invest to meet the Brazilian market’s particular needs. The technology was developed by the Brazilian arm of Magneti Marelli, a wholly owned subsidiary of Fiat, and Robert Bosch, a German component-maker that has a close relationship with VW. Both car firms began equipping their vehicles with flex-fuel engines in 2003, and now such engines power nearly every car being made in Brazil. About half the fuel used by cars today in Brazil is ethanol.

For ordinary Brazilians the attraction is that it sells for little more than half the price of normal petrol, although its range is slightly shorter. The government is also keen on ethanol because the industry employs over a million people, saves on imports and provides insurance against high oil prices. It is also relatively clean, producing lower “well-to-wheel” emissions than petrol, unlike the corn-based ethanol being sold in America; and it is sustainable, taking up only 2% of land currently in agricultural use.

Both Fiat and VW emphasise the need to develop their cars locally. Bumpy, unmetalled roads call for good ground clearance and heavy-duty suspensions. Cars designed for European conditions would fall apart in just a few months in Brazil, says Fiat. Both makers have recently taken to producing what are known as “SUV-lite” versions of ordinary cars. There is a tough-looking Palio “Adventure” and a beefed-up small VW hatchback called the CrossFox. But the market is dominated by fairly spacious cars with small engines. Cars with engines up to one litre attract a lower level of purchase tax, making them the choice of more than half of Brazilians buying a new car. Cheapest of the lot is a Brazilian version of Fiat’s Uno, the Mille. Although it falls some way short of modern safety standards, the Mille has racked up sales of more than 2m in Brazil and is still going strong.



The biggest worry for Brazil’s big four is that the car business is rapidly becoming more competitive. Two French makers, PSA Peugeot Citroën and Renault, took nearly 8% of the market last year, followed by the Japanese, led by Toyota and Honda. Toyota is building a second factory in São Paulo that will come on stream in 2010 and produce a smaller, cheaper car than the Corolla it currently makes. The South Koreans are beginning to take an interest too. Jackson Schneider, the president of ANFAVEA, a trade body, predicts that by 2013 Brazil will be the world’s sixth-biggest car producer, turning out more than 5m cars, 4m of them for the domestic market.

Still guzzling in Russia

The rapid rise in oil prices that dragged most vehicle markets down this year had the opposite effect in Russia. Thanks to abundant natural resources the economy has grown at an average of 7% a year for the past decade and only now shows some signs of flagging as commodities prices drop. In the past five years real disposable incomes have doubled. Speaking earlier this year, Heidi McCormack, GM’s head of business development in Russia, noted that compared with more developed markets Russia had been “magically isolated.”

When the economy began to recover from the crisis of the late 1990s, Russians, scornful of their own car industry’s Soviet-era products, began buying ever more used imported cars. In 2002 they snapped up nearly 500,000 of them, mainly from Germany and Japan. Even quite elderly VWs and Toyotas were a revelation of modernity, quality and price compared with the Ladas of AvtoVAZ and the Volgas of Gaz. In response to desperate pleas from Russian carmakers the government agreed to slap a steep duty and VAT on imported cars to choke off the supply.

However, the domestic carmakers were in no position to take advantage of the breathing space. Three years later new imports were taking nearly half the market, despite high duties. Impatient with the local firms but determined to revive its domestic industry, the government in 2005 passed a law designed to entice foreign manufacturers to assemble their products in Russia. To qualify for relief from import duty, foreign carmakers had to build a factory with a capacity of more than 25,000 vehicles a year and invest at least $100m. Within five years the local content of each car had to reach 30%. But unlike in China firms were not required to establish partnerships with local producers.

The pioneers in Russia have been Ford and GM. In 1999 Ford dipped a toe in the water with a small assembly plant near St Petersburg, and in the same year GM went for a seemingly risky joint venture with AvtoVAZ (at the time a byword for corruption and gangsterism) to produce an improved version of the Niva, a cheap SUV. More recently others have joined the scramble. Renault, as part of a deal with Moscow’s city government, took over an old Moskvich factory in 2004 to build its low-cost Logan, and VW in 2006 began construction of a new factory in Kaluga, 120 miles (190km) south-west of Moscow, where

Mitsubishi and PSA Peugeot Citroën are also setting up.

Most of the others have gone to the St Petersburg area, where Ford and GM have been steadily expanding their capacity. Toyota is now producing Camrys there and will soon be joined by Nissan, Suzuki and Hyundai. St Petersburg owes its popularity to its ice-free port, good rail links and well-educated workforce, as well as the can-do approach of the governor, Valentina Matviyenko, who has promised to turn the city into Russia’s Detroit. Much of the traffic on the 450-mile road to Moscow is made up of car transporters. GM and Ford still have about 20% and 10% respectively of the market, but competition is hotting up.

By 2012 ten of the world’s biggest car companies will be manufacturing up to 1.6m vehicles a year in Russia, with a large components industry growing up around them. Eduard Faritov, an analyst at Renaissance Capital, an investment bank, thinks that Russians will be buying nearly 5m new cars a year by then, and 80% of them will be foreign brands. Nigel Brackenbury, head of Ford’s operations in Russia, notes that for most of the past decade foreign brands have mopped up all the growth in the market. Ford, he says, now sells more cars in a week than it did in a year when it first started out. Over time Mr Faritov expects the foreign manufacturers based in Russia to supply an increasing proportion of the market as their capacity increases. New imports will continue to make up a large segment of the market, but will be concentrated at the top end and in niche markets. The future of the biggest domestic maker, AvtoVAZ, will depend on the outcome of a joint venture with Renault sealed this year in which the French firm acquired a 25% stake for $1 billion.

What Indians want

Few joint ventures between a local firm and a foreign manufacturer have been as enduring and profitable as that of Maruti of India and Suzuki, a Japanese small-car specialist. Set up in the early 1980s as a government project to produce a cheap modern car for middle-class Indians, Maruti Suzuki still dominates the Indian market, with a 54% share in 2007-08. Indians still think of Maruti as an Indian company, but the company’s range now consists almost entirely of modern Suzukis, such as the best-selling Alto and the more expensive Swift. With 54% of the equity, the Japanese company is firmly in the driving seat.

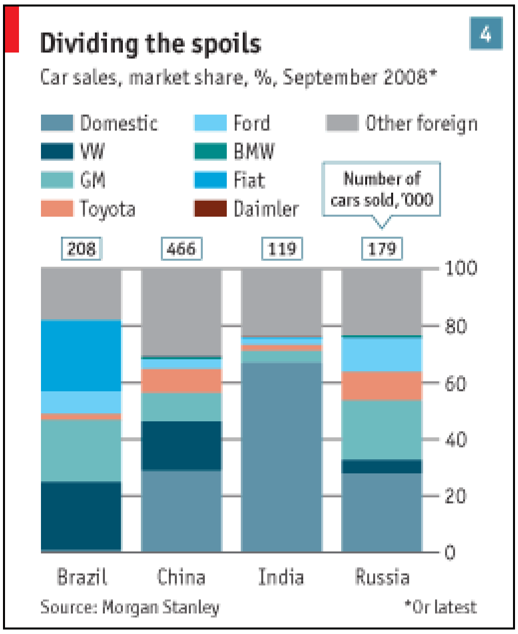
A more recent success story is that of Hyundai, one of many foreign manufacturers that entered the Indian market after the economy was liberalised in the 1990s. Faced with an import duty of 91% on small cars assembled from “semi-knock-down” and 31% even for assembly from “complete knock-down”, Hyundai, in common with its foreign rivals, decided to move straight to full manufacturing in India. But it did so on a much grander scale than others, investing an initial $1.2 billion there.

A decade ago Hyundai began production of the Santro, a small car with a high roofline for added space, from a state-of-the-art factory on the outskirts of the southern city of Chennai. The South Korean firm now occupies second place in the market with an 18% share, pushing Tata Motors, India’s only big entirely indigenous maker, into third place with 14%. Hyundai India’s managing director, Heung Soo Lheem, claims that Hyundai is the only car firm in India to manufacture a complete range of cars locally. At the end of last year it doubled its capacity to 600,000 units with the opening of a second assembly line to build an important new car, the i10.

According to Mr Heung, this is the first fruit of Hyundai’s decision to make India its world production centre for cars under 1.5 litres. Up to half of the i10s produced will be exported. M. Inderjith, the factory’s manager, says that means the quality will have to be world-class. The car is already on sale in Europe, where it has won excellent reviews. For India it is also a step forward in sophistication at an important price point. Even basic models selling for 350,000 rupees ($7,000, or just over £4,000) have air-conditioning and tinted glass (airbags and anti-lock brakes are reserved for more expensive versions). Although the i10 factory is highly automated, low labour costs still make it 10% cheaper to manufacture in India than in Korea.

GM has doubled its sales in the past year, growing even faster than Hyundai, though from a lower base. But what is winning over the Indians is not GM’s American or European models but the small, cheap cars badged as Chevrolets and made in Gujarat by its South Korean subsidiary, Daewoo. Ford, which has invested only a relatively modest $150m in the country, has struggled to build up a significant volume, despite its early arrival in India. It

offers the Ikon, a saloon based on an old Fiesta platform which is sold only in India, as well as a more up-to-date booted version of the Fiesta and the chunkily styled Fusion, but its Indian production this year will be only about 35,000 units.



Michael Boneham, an Australian who has been sent to turn round Ford's fortunes in India, expects this to change soon. Between now and 2010 Ford will spend $500m, doubling its capacity to 200,000 units and developing a new small car to compete with Chevrolet's Spark and Hyundai's i10 in the 300,000-500,000 rupees price range that accounts for nearly 70% of car sales in India. Mr Boneham says that with greater choice Indian customers have become more demanding, expecting even fairly low-cost cars to be well specified. Getting costs down to the lowest possible level is only the first, albeit essential, step to providing the right quality and value. Like Hyundai, Ford intends to export its new small car in quantity, mainly to the Asia-Pacific region and parts of Africa.

Five lessons

What wider lessons can the world's car companies learn from their experiences in the four markets that will provide most of their growth in the years to come? The first is that they must show commitment. Getting there early brings big advantages, but they have to be built on. Fiat has done well in Brazil—even though it arrived after Ford and GM—because it understood the market better, trusted its local management and invested heavily. Hyundai and Ford pitched their tents in India at about the same time, but Hyundai took the country's potential far more seriously and is reaping the benefits.

The second lesson is that no single business model works in every country or for every company. In China the ability to manage joint ventures has paid off handsomely for VW and GM. To make up ground in China, the Japanese, never previously comfortable in joint ventures, are having to learn new skills and be more relaxed about the transfer of intellectual property. In Russia most of the new foreign-brand entrants, except for Renault and Fiat, are going it alone. Both firms wooed AvtoVAZ when others decided to give the Russian carmaker a wide berth. Although Fiat lost that contest, it has teamed up with another local company, Severstal Auto.

The third lesson is that local conditions and local tastes must be catered for when adapting existing models that have done well in mature markets. In Brazil and India that has meant building small, fuel-efficient cars that are also spacious and rugged enough to withstand bad roads and some of the world's most vicious speed bumps. In China it has meant indulging newly affluent and highly status-conscious customers who like biggish saloons with smart interiors and lots of gadgets but are less interested in performance because there are few decent roads outside the big cities. Russians, for their part, love SUVs in all shapes and sizes. Even though most owners never leave Moscow or St Petersburg, they like the idea of a go-anywhere vehicle that can take Russian winters in its stride.

The fourth lesson is that although their tastes may differ, BRIC customers are no longer prepared to put up with outdated or inferior offerings unless they are very cheap indeed, like the Fiat Mille in Brazil or the Maruti 800 in India. Specialist magazines, the internet and, above all, increasing competition among the manufacturers have greatly raised buyers' expectations in just a few years.

The final lesson is not to get carried away by big numbers. Although it seems almost certain that sales will grow on a scale never seen before, the sheer intensity of the competition may make large profits elusive. China is already on the verge of profitless growth. Last year average prices fell by 5.7% and now a new wave of price-cutting is under way to boost flagging demand. Dealers in China increasingly depend on financial contributions from the manufacturers to make any money on sales of new cars. As Sergio Marchionne, the boss of Fiat, recently remarked: "When it comes to China you're either damned if you do or damned if you don't."

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The home team

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From The Economist print edition

Indigenous carmakers are working their way up

RATAN TATA may be the patriarch of Indian business and head of the sprawling conglomerate that bears the family name, but few doubt that his first love is Tata Motors. The company dominates the Indian commercial-vehicle market, produced India's first entirely indigenous modern car and has captured the world's imagination with the Nano—the one-lakh (100,000 rupee, $2,500) "people's car".

Sitting in his office on the top floor of the building in central Mumbai from which he controls his empire, Mr Tata recalls what brought him into the car business a decade ago. In the era known as the "Licence Raj", from independence in 1947 until 1990, when India attempted to operate a planned economy, the Indian car industry was suffocated by red tape. Until the birth of Maruti in the 1980s the market was supplied by just two manufacturers: Hindustan, which made a version of the 1950s Morris Oxford, and Premiere, which produced the similarly elderly Fiat 1100.

Hindustan and Premiere were licensed to make just 50,000 cars a year between them. Imports, other than personal ones, were virtually unknown. If the companies exceeded their licence quotas they could be prosecuted and fined. "These two firms were able to keep everyone else out of the market. If you wanted a car, you had to wait for seven years," says Mr Tata. When the government-backed Maruti appeared on the scene, it applied for a licence to make 150,000 cars a year, which at the time seemed a huge number. Offering India its first modern car for 30 years, Maruti quickly became pre-eminent in the mid-1980s.

As the market was gradually liberalised, Tata found itself courted first by Honda and then by VW and Toyota. But instead Mr Tata decided that Tata Engineering and Locomotive Company (Telco), the forerunner of Tata Motors, should develop and manufacture its own car, believing that Telco had the scale and the knowledge not to depend on a joint-venture partner.

The aim was to produce a vehicle with the internal dimensions of the stately Ambassador (because most Indian car-owners have drivers and sit in the back) and the fuel-efficiency of the Maruti 800. The result was the Tata Indica, a modern hatchback with a diesel engine, styled by IDEA in Italy. Launched in January 1999 in the middle of a recession, the Indica soon established itself as the market leader in its price band, despite some early quality problems. Ravi Kant, Tata Motors' managing director, concedes that "as a first attempt it was OK, but there were weaknesses in finish and handling that needed improving."

Now approaching its 10th birthday, the Indica, in all its versions, has sold nearly 1.4m units and is still the second-biggest-selling car in India. Yet despite its competitive price the car is beginning to slip behind newer rivals, such as Hyundai's i10 and the more expensive Maruti Suzuki Swift. Tata's answer is the recently launched Indica Vista, a bigger, more sophisticated car built on an all-new platform and available with Fiat's advanced multijet diesel engine.

Mr Kant describes the Vista as a quantum leap that Tata had to make to compete with the foreign brands as they introduce more cars in the important 300,000-500,000 rupee price band. He also believes that the Vista is good enough to appeal to budget-conscious buyers in Europe. Early reviews have been positive, but Tata will have to work hard to come closer to the build quality of its South Korean, Japanese and European rivals and still beat them on value.

The modern factory in Pune where the Vista is assembled is noticeably less automated than Hyundai's Chennai facility where, for example, body-welding is carried out almost exclusively by robots. Tata reckons that because of relatively low Indian wages it is still worth doing certain things manually that would be automated elsewhere. But it means that more than 20% of the cars made by Tata require some rectification before they leave the factory, against under 5% of Hyundai's i10s.

The joys of joint ventures

If India has only one fully indigenous carmaker that competes with the world's giants, China has perhaps as many as five that see themselves as potential rivals to the foreign brands which last year took more than 70% of the Chinese passenger-car market. Mr Ghosn of the Renault-Nissan alliance says that in a country with a manufacturing base as strong as China's it is "abnormal" for foreign firms to be so dominant and that "at least one" Chinese maker will become a big force with a market share of around 20%. Yet predicting who will be the winners in this huge market is not easy.

The Chinese car industry began to take shape in the mid-1980s as the economic reforms of Deng Xiaoping gathered pace and the country opened for business with the rest of the world. Until then the country's motor industry had concentrated almost entirely on trucks and buses. When Mao died in 1976, vehicle production was running at about 150,000 a year. First Auto Works (FAW), the country's biggest maker, had been producing Hongqi (Red Flag) limousines for party bigwigs since the late 1950s, and Shanghai Auto Works turned out the slightly smaller Shanghai SH760 saloon for less important officials. Neither changed much during its 30-year production run. In the absence of any competition they did not need to.

The arrival of VW and then GM as joint-venture partners for the state-owned FAW and for Shanghai Tractor and Automotive (today's Shanghai Automotive Industry Corporation, or SAIC) marked the start of a new era. The bargain was that in exchange for access to the vast Chinese market the foreigners would supply the investment and know-how to create a modern car industry from the scorched remains of the Great Leap Forward and the Cultural Revolution.

Reuters

Time for Chery-picking

The success of those first joint ventures prompted a stampede of the world's other big carmakers to form partnerships in China. The terms were largely dictated by the Chinese government, which knows full well that there are a dozen big car manufacturers but only one Chinese market. Every foreign manufacturer has been prodded into creating and expanding local technical centres, partly to modify Western and Japanese designs for the Chinese market but also to train Chinese engineers and speed up the transfer of both product and manufacturing technology.

Since only China's big five carmakers (SAIC, FAW, Dongfeng, ChangAn and Chery) have the heft to be effective partners for the big international car firms, there has been some doubling up. For example, SAIC works with both VW and GM; FAW with VW and Toyota; Dongfeng with Nissan, PSA Peugeot-Citroën, Kia and Honda; and ChangAn with Suzuki, Ford and Mazda (which is 34% owned by Ford). This has allowed the Chinese companies to play one partner off against another when they were not getting exactly what they wanted.

Doing their own thing

It is clear that one of the things they want is to be full-range carmakers in their own right. At this year's Beijing motor show Dongfeng, which is investing $1.3 billion in a new R&D centre and a factory in Wuhan with an eventual capacity of 333,000 units a year, displayed its first own-branded car, the Jingyi, a crisply styled compact minivan that looks a bit like Renault's Scenic.

FAW, recognising that its old Red Flag brand may not be quite right for the times, has started building a range of vehicles under the name Besturn. It already has a largish saloon that competes with the Buick Regal and will be introducing a clutch of new models over the next year or so, including a smaller saloon and an SUV. FAW is planning a model line-up that runs from small to luxury cars. One of those cars will be a version of the highly successful first-generation Yaris. FAW has committed $1.83 billion to developing the vehicles between now and 2015.

SAIC has taken a slightly different path. In 2004, as part of negotiations to try to save the now-defunct MG Rover from collapse, it acquired the intellectual-property rights to most of the formerly BMW-owned Birmingham-based company's technology. At about the same time it did a deal with a British automotive consultancy, Ricardo, to set up an R&D operation in China. The first fruit of SAIC's British connection was the Roewe 750, an updated version of the Rover 75 (Ford, then owner of Land Rover, refused SAIC permission to use the Rover brand) that was launched two years ago.

Since then, with strong government encouragement, it has acquired China's oldest car firm, the much smaller cash-strapped Nanjing Auto, which had bought Rover's MG brand, some blueprints and the factory where the MG roadster was built. SAIC is now building the ageing sports car in Birmingham again and has kept Nanjing's MG version of the Rover 75 going, perhaps to sell in export markets.

SAIC's latest car, the handsome Roewe 550, developed from MG Rover plans with help from Ricardo, made its debut at the Beijing show earlier this year. Although powered by the slightly long-in-the-tooth Rover K-series engines, the 550 is the first Chinese car that might appeal to European tastes. And being built on a cut-down version of the impressively strong 75's platform, it should stand up well to crash tests, which is more than can be said for some of the other Chinese hopefuls.

Among China's horde of independent carmakers, the most promising appear to be Chery and Geely. At the Beijing motor show Geely showed 23 different vehicles (including a bizarrely modified London taxi), 13 of them entirely new designs. The firm, which sold 220,000 units last year, is developing no fewer than five new platforms and says it will launch 42 new models between now and 2015. By then, says its vice-president, Frank Zhao, Geely will have the capacity to turn out 1.7m cars a year from nine different factories in China and more from overseas plants, probably in Mexico, South Africa, Indonesia, Ukraine and Russia.

Geely suffered a setback to its world-conquering plans when a Russian car magazine crash-tested a Geely CK small saloon at 64kph (40mph). Both driver and passenger were given a survival chance of only 10%, dashing hopes that exports to America might begin in late 2007. Geely still talks bullishly about launching in America by 2010, but 2013 now seems more realistic.

Chery, Geely's bigger but less brash rival for the title of local hero, recognises that before it can sell cars in developed countries it needs to do much more work. "North America and Europe have very demanding safety and emission laws that our vehicles do not meet yet," says Yin Tongyao, the company's president. Part of the problem, he says, is the quality of the Chinese suppliers of components that Chery has depended on: "It is improving, but it is still not as good as it should be." The answer may be to buy more from the big global parts-makers. Several of them have set up shop near Chery's Wuhu base and established joint ventures in the hope of profiting from the firm's future growth.

The shortcomings identified by Mr Yin undermined a deal with Chrysler last year to help the troubled American firm build a much-needed small car for the American market. Chrysler subsequently turned to Nissan, but Chery will supply a Chrysler-badged small saloon for Latin America. Most recently Chery has signed an agreement with Fiat, left without a partner in China after SAIC's takeover of Nanjing, to assemble kits of the Linea, Grande Punto and Alfa 159 from next year.

This summer Chery announced it would soon start building a fourth factory with an annual capacity of 200,000 cars. That will bring its total capacity to 850,000 units by 2010, making it one of the biggest manufacturers in the country. This year it expects to sell nearly 500,000 cars in China and has started to introduce a wave of new models to keep customers interested.

Last year China's home-grown brands took 29% of the market, increasing their share by only one point over the previous year. That was partly because the independent carmakers' offerings were largely small and cheap at a time when status-hungry buyers were turning increasingly to bigger cars. Sales of luxury cars increased by 35% and those of SUVs by 50%, whereas sales of small cars rose by only 4%. But another reason was that the Chinese still look down on their native brands, often with good cause. Still, things are changing. Government officials talk of Chinese domestic brands taking up to 60% of the

market in a few years' time.

AFP

A Lada for all seasons

For the moment that seems like wishful thinking. But the Chinese are learning fast and rapidly gaining scale. Cynics say that the foreign makers have never been more than a means to an end, and once they have served their purpose the market will slowly be stacked against them.

They are probably wrong. China is conscious of its obligations as a member of the World Trade Organisation, and Chinese consumers are brand snobs who increasingly expect to be able to buy the best. Yet with its gigantic home market and a supportive government (which directly or indirectly owns most Chinese car firms), it would be surprising if in ten years' time China did not have at least a couple of car firms competing on equal terms with the world's giants.

By contrast, the chances of any Russian carmaker becoming a global force are remote. In 1990 Russian car manufacturers produced 1.2m passenger vehicles. Last year they sold just 756,000.

Bearish outlook

Gorky-based Gaz, maker of the big, tough Volga saloons beloved by Soviet officialdom (which are still being produced), has just started building the more modern Volga Siber, based on the platform of the previous Chrysler Sebring. However, Gaz sees its future not so much in cars as in heavy trucks, buses and light commercial vehicles. Severstal Auto, which makes the Soviet-era UAZ Hunter 4x4 as well as some more modern utility vehicles and a range of truck engines, has reached a similar conclusion. Although it assembles SsangYong SUVs under licence from the South Korean maker and has a joint venture with Fiat to produce its Albea and Linea sedans, it thinks commercial vehicles are a safer bet.

AvtoVAZ, which owns Lada and makes more than 90% of Russian-branded cars, has had a torrid recent history. In the 1990s it became a byword for the gangsterism that characterised much of post-Soviet Russian capitalism. Many of the firm's dealers operated as a criminal network, buying cars cheaply, paying late and selling them to Russian consumers at a huge mark-up. AvtoVAZ managers were well rewarded for their co-operation. Criminal gangs roamed the factory, removing finished cars from the assembly line and delivering them to shadowy third parties. Dealers who refused to participate in the scam would find the cars they received had been vandalised. There were frequent shoot-outs at the giant Togliatti factory built with Fiat's help in the 1960s. Since 1992 over 500 people associated with AvtoVAZ have been murdered.

By 2005 the Putin government had had enough. It got the state-owned arms-export company, Rosoboronexport, to buy a controlling stake in the car firm for $700m. AvtoVAZ's ownership remains tangled, but in effect the company was renationalised. Rosoboronexport's boss, Sergei Chemezov, an old KGB friend of Mr Putin's, turned up in Togliatti with 300 heavily armed policemen to seize control of the factory and replace the management with Kremlin trusties.

Mr Chemezov may not have known much about the car business, but he and his chief executive, Boris Alyoshin, appear to have brought some stability to AvtoVAZ and cleaned it up sufficiently to lure Mr Ghosn's Renault into taking a stake of just over 25% in the business earlier this year. As part of the $1 billion deal, Renault has committed itself to help turn AvtoVAZ into a modern car company. Senior

Renault managers, including some of those who contributed to the revival of Nissan's fortunes, have been arriving at Togliatti since March. Mr Ghosn is also one of three Renault executives on the AvtoVAZ board.

Mr Ghosn says this is a relationship "whose time has definitely come". He believes that it will give Renault access to capacity that it would otherwise have had to build expensively for itself, as well as to the large (and supposedly decriminalised) AvtoVAZ dealer network that stretches across the country's 11 time zones. Mr Chemezov says that Renault will bring modern technology and know-how, and Mr Alyoshin reckons that with Renault's help a sales target of 2m units may not be too far away.

With its long experience of working within an automotive alliance, Renault is probably the best partner the ailing Russian firm could have found. But the task is daunting. AvtoVAZ's share of the Russian market is in rapid retreat. When Mr Chemezov arrived, it was 37%; this year, with luck, it may remain at 20%. Ladas, both the old Fiat 125-based "Classic" and the newer but still substandard Samara, have continued to sell in provincial Russia because the cars are very cheap, lots of dealers sell them and there are still few alternatives.

One big threat to the Lada is the incipient invasion of low-priced locally assembled Chinese cars. Several Chinese companies have applied for licences to build assembly plants in Russia, but so far only Chery has been given the go-ahead, whereas Western or Japanese firms have never been refused. This is not because the Chinese do not meet Russian safety standards, as is sometimes argued, but because the Chinese compete with AvtoVAZ on price. In the longer run such discrimination may not be sustainable.

The second threat is that the dynamics of the used-car market are about to change again. AvtoVAZ was given a breathing space in 2002 when the government imposed heavy import duties on used cars coming from Japan and Europe, and was also helped by an 18% value-added tax levied on all used sales through dealers. After much lobbying by the car industry the government appears ready to lift that tax soon. With ever larger numbers of high-quality Russian-built foreign-brand cars likely to come on to the secondhand market in the years ahead, much of Lada's price advantage will disappear.

Renault says it aims to launch a succession of new Ladas using its low-cost Logan-based platforms that will be competitively priced and offer much higher quality than AvtoVAZ does at present. The first should reach the market by 2010. Yann Vincent, a Renault executive who is now the chief operating officer at Togliatti, says that of the four assembly lines at the run-down factory only one is usable; the other three are obsolete. Though he does not say so, the factory is also extraordinarily inefficient. It needs 104,000 people to maintain its current production of around 700,000 vehicles a year. For comparison, about 10,000 workers will produce up to 400,000 cars at Renault's Dacia factory in Romania next year.

Nor is it just a matter of bringing in new machines. The biggest problem, according to Mr Vincent, is the supply of components. Most Lada parts are shoddily made in-house; others are brought in from Latvia more than 1,200 miles away. Patrick Pelata, a veteran of the Nissan turnaround, says he wants to attract "global parts suppliers" to Togliatti. He hopes that within five years 95% of the parts for "Logan-Ladas" will be made locally.

Renault's involvement should ensure that AvtoVAZ can avoid a collapse in sales and output. But Eduard Faritov of Renaissance Capital, who has studied the firm's prospects, thinks that AvtoVAZ will have to run hard just to stand still. Intensifying competition combined with rising safety and environmental standards will push most of today's Ladas out of the market and shorten the life cycle of new models. He forecasts that by 2015, although AvtoVAZ will still be selling around the same number of cars as it does today, its market share will have fallen to 11%. Not even the resurgence of Russian nationalism, it seems, can save the country's last important carmaker from its steady decline.

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Pile them high

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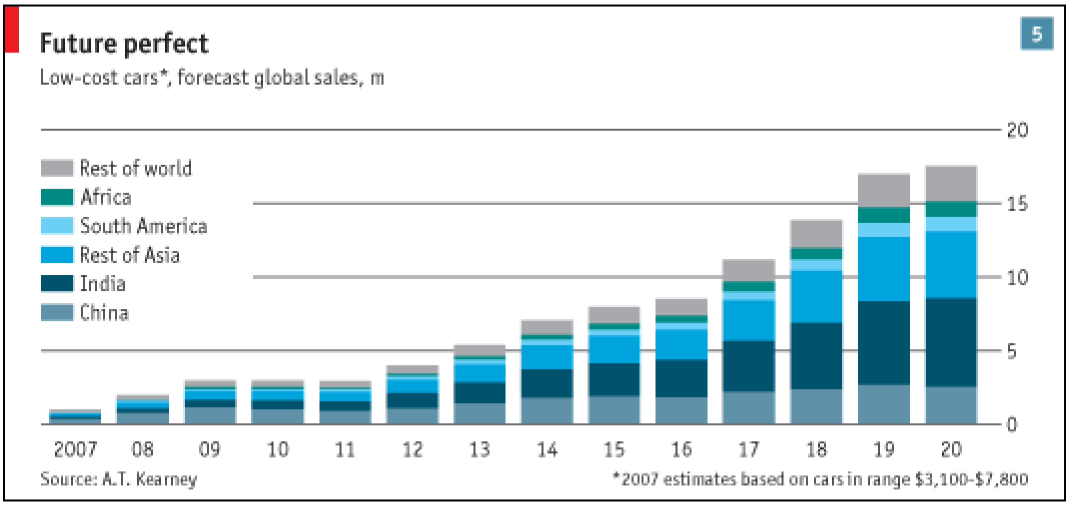
From The Economist print edition

The cheap-and-cheerful end of the market

WHEN in 1999 Renault spent $50m to acquire a controlling stake in Dacia, a sickly Romanian carmaker formerly owned by the state, it was unimaginable that it would become one of the jewels in the French car firm's crown. This year, at its factory in Pitesti, not far from Bucharest, Dacia will churn out more than 300,000 Renault-Dacia Logan saloons and its cousins. In 2009 the number is expected to rise to 400,000, including kits exported to other Renault assembly plants. Five months ago the millionth Logan since its launch in 2004 rolled off the line. The chances are that it was a car from Pitesti, the Logan's "mother plant", but it could have come from any one of seven other production sites in Russia, India, Iran (with two), Morocco, Brazil or Colombia.

Conceived as a low-cost car for emerging markets, the boxy-looking Logan has become one of Renault's most profitable vehicles. Whereas Renault's margins across its range are an anaemic 3%, the Logan earns at least twice as much. By 2010 Renault expects to be making more than a million Logans a year, despite its failure to find a partner in China to build them. No wonder most global manufacturers are jostling to get into the low-cost game.



But what exactly is a low-cost car? Mark Bursa, the emerging-markets commentator of Just-auto, a car-industry website, argues that the term can include anything from Fiat's rather upmarket Linea saloon and the Logan to "legacy" cheapies such as the ancient Lada Zighuli and the Maruti 800, a five-year-old VW Golf or Tata's innovative "one-lakh car", the Nano. But used cars imported by poor countries from rich ones become expensive when weighed down with high duties and taxes to protect indigenous industries. And Mr Bursa acknowledges that cars such as the Lada and the Maruti, both based on 40-year-old designs, will not be rolling off the production lines for much longer. They are cheap because all the investment to make them was written off long ago, but they find it increasingly hard to comply with ever-tightening emissions laws and safety regulations. Fiat's Mille, sold in Brazil, which evolved from the Uno of the early 1980s, has a clean flex-fuel engine, but the company accepts that there is little that can be done to make it safer in a crash and is working on a successor.

The genuinely low-cost cars of today are those, like the Logan, that were designed from the outset to come close to the standards of their manufacturers' latest mainstream models but to be much cheaper to develop and make. The Nano is in a different category, of which more later.

Although Renault has earned considerable kudos for having made a success of the Logan, the real pioneer was Fiat with its Project 178, born at the beginning of the 1990s. With the collapse of the Soviet Union and the opening up of India and China, Fiat reckoned it could use its experience of the Brazilian market to develop a range of tough, inexpensive but modern cars that could be built and sold almost anywhere in the world. The results were the Palio hatchback, the Siena saloon, also known as the Albea,

an estate car and a pick-up. The cars have been a success in Brazil and the Albea has also done well in Turkey, but neither made the expected impact in Russia or China. Fiat says that it has learnt valuable lessons which it has applied to the Linea and the all-new successor platform to the 178, due next year.

The lure of the Logan

However, it is the Logan that has come to be seen as the first low-cost world car. Like the Palio, the Logan uses a strengthened and stretched version of an existing small-car platform, but Renault had a more rounded strategy than Fiat did in the 1990s. It set out to build a car that could sell for $6,000 by keeping down development costs and taking almost everything that would go into the car from existing or earlier models. Renault also made the Logan cheap to produce by keeping it simple (for example, its dashboard is a one-piece moulding). Most of the machinery at Pitesti is refurbished kit from Renault's factories in France. Research by Deutsche Bank in 2005 suggested that production costs of the Logan were less than half those of a standard European compact car. Mr Bursa reckons that as volume has increased, bringing greater economies of scale, the comparison may now be even more favourable.

In some ways even Renault has been surprised by the car's success. For example, it has had an enthusiastic reception in western Europe, where it is sold as a Dacia. Its spaciousness, rugged build and relative simplicity appeal to buyers who prefer a well-priced new vehicle to a secondhand one. A second, and even more welcome, surprise has been that the Logan has achieved its planned volume without having to be sold at a price anywhere near as low as the frugal $6,000 it was designed for. Renault claims the average selling price is nearer to $9,000, and in Europe almost $13,000 because buyers want extras such as air-conditioning, electric windows and anti-lock brakes.

AP

Ratan's baby

How long Renault will be able to go on making such a handsome profit from the Logan is debatable. Its market is growing by leaps and bounds. According to RL Polk, a market-research firm, sales of cars below $14,000 will grow by 70% in the next nine years, compared with an increase of 30% for all vehicles. And Robert Bosch, a components supplier, forecasts that sales of cars priced at $10,000 or less will have grown to 10m by 2010, making up about 13% of the world market. But other makers are getting ready to crash Renault's party.

Toyota's eagerly awaited low-cost competitor, known as EFC (Entry Family Car), is expected to make its debut in 2010. Little is known about the EFC, but it is thought to have a target price of $6,500 and is likely to be built in both Brazil and India to start with. Toyota's boss, Katsuaki Watanabe, says he is using the EFC project to bring about a revolution in manufacturing efficiency at the already famously lean Japanese firm.

Around the same time Fiat's successor to the Palio/Siena should also have surfaced. Meanwhile GM is using its South Korean subsidiary, Daewoo, to develop a car which it hopes will be even cheaper than the EFC. To meet the challenge, Renault is aiming to get its next-generation low-cost car ready by 2011, although the Logan is likely to continue in production for a while after that. According to Gerard Detourbet, the head of the Logan programme, the Logan's successor will be bigger, better-looking and even cheaper. It may need to be.

What it will not be is competition to the Tata Nano. Ratan Tata, the boss of the Tata group and the driving force behind the Nano, says that he was "amused" to discover that when the Logan went on sale in India last year the price of the basic model was around 500,000 rupees (nearly $11,000). "It was just another car," says Mr Tata sniffily. Nobody could say that of the Nano. Conceived by Mr Tata five years ago as a safer and more comfortable alternative to transporting a family of four on a small two-wheeler, a common sight on Indian roads, he was determined to price it half-way between a motorcycle and India's cheapest new car, the venerable Maruti 800. Mr Tata later promised that the Nano would be a real car that could be bought for just one lakh (about $2,500)—a commitment he triumphantly honoured when the little jellybean-shaped car was revealed at the Delhi motor show in January this year.

A legend before its lifetime

The Nano is not just very cheap; to be so cheap it also has to be very clever. Mr Tata, who remained closely involved with the enthusiastic young development team during the car's gestation, says there were three possible ways they could have gone: work down from a car design, work up from a scooter or start with a clean sheet of paper. By going for the third option, Tata has created a new template for developing ultra-low-cost cars that others will almost certainly have to follow.

The Nano team, led by Girish Wagh, says that one of the keys to success was that they were ready to try different ideas and accept that some of them might not work. The team even asked whether there was a need for doors and whether plastic instead of steel could be used for the bodywork. According to Mr Tata, the answers were respectively yes and no. The overall outcome was a culture defined by frugality and a willingness to challenge convention, dubbed "Gandhian engineering".

The Nano's body was completely redesigned twice and the engine three times. A critical decision was to simplify assembly by mounting the engine, exhaust system and gearbox in a single module in the space behind the rear seats. Indeed most of the car is broken down into modules that can easily be assembled from kits. Mr Tata hopes to "create entrepreneurs across the country that would assemble the car". Costs were shaved by keeping everything light and simple. The car has only one windscreen wiper; its wheels are held on by three bolts, not four; the steering column is hollow; instead of long-life headlight bulbs designed to last ten years, cheaper bulbs are fitted that can be easily replaced. Even the number of tools needed to make the car was cut down.

Suppliers were urged to adopt the same frugal engineering. Some concluded that the cost goals were just too onerous and walked away. Others, such as Lumax Industries, an Indian automotive lighting specialist, were pleased to be involved from the outset of the project. According to Deepak Jain, the chairman of Lumax, "the opportunity to work on this car gave our engineers the chance to showcase their skill. Because most other car products are designed abroad, we just have to manufacture components to a specific blueprint. In this project we designed light fixtures that meet all regulatory needs, fit the car and are low-cost." Perhaps more surprisingly, Robert Bosch, the world's biggest components company, agreed to supply a stripped-down version of its Motronic engine-management system.

The immediate prospects for the Nano have been somewhat clouded by two developments. First, the steep climb in prices of raw materials, especially steel and polypropylene (used to make plastic), after the car was unveiled in January raised fears that Tata might lose up to $90 on every basic $2,500 Nano it sold. An analysis by A.T. Kearney, a consulting firm, suggested that the cost of producing the little car had risen by about $165. But those fears have eased a little in the past month or so as commodity prices have fallen back in response to a drop in global demand.

The one-lakh bind

The second, and more serious, setback has been the decision to abandon the factory built specially for the Nano in Singur, West Bengal. Violent protests by farmers over the state's forced purchase of their land for the 1,000-acre site, at prices they said were below market value, left Tata with an invidious choice: negotiate directly with the farmers and buy them off, or walk away.

On October 7th Mr Tata confirmed that production of the Nano, and the 10,000 jobs that went with it, would be moved to a new site in Gujarat where, crucially, the state government already owned the land. Tata is thinking of shifting some of the initial production to its existing factories in Pune or Pantnagar, but even so the Nano's launch will now be delayed until early 2009. Once under way, however, production at the new factory will quickly climb to 250,000 a year and can be expanded to 500,000 a year.

Mr Tata is clearly distressed by what has happened. He says that bringing the $400m Nano investment to West Bengal was "a leap of faith" intended to bring the car industry back to a state that had been starved of investment because of its history of left-wing politics. Impressed by the state's business-friendly chief minister, Buddhadeb Bhattacharjee, Mr Tata hoped that other firms would follow his lead in coming to West Bengal. Now they are more likely to stay away.

It should be possible to move all the machine tooling from Singur, albeit at considerable expense and disruption for Tata, as well as for the suppliers who were setting up nearby. Mr Tata concedes that "we will limp initially, and at a higher cost." Ravi Kant, managing director of Tata Motors, hopes that any

additional costs from dearer raw materials and the exodus from Singur will be compensated for by most customers opting for the higher-margin, pricier “de luxe” Nano that comes with air-conditioning, electric windows and little alloy wheels.

In the longer term, the Nano’s success will depend on how people react to the car and whether Mr Tata is right that there is a big gap between what he calls “the low end of the car market and the high end of the two-wheel market”.

A handful of sneak reports on what the Nano is like to drive are already circulating on the web. They suggest that the goal of making a “proper” car has been achieved. Although noisy, the tiny 32bhp engine provides enough puff to reach the claimed maximum speed of about 60mph. Despite the tall roof and the weight carried over the rear wheels, the Nano handles quite predictably and is particularly nimble at city speeds. Given its tiny size it is astonishingly spacious inside and comfortably seats five people. The interior plastics and the fittings look cheap, but then the car is cheap. However, the overall feeling of flimsiness is harder to shrug off. Still, Mr Tata says the Nano has been engineered to pass a variety of crash tests.

The potential market could be huge. Sales of two-wheelers in India are running at about 7m a year (see article). Although it will be more expensive to buy and run than a motorcycle, the Nano offers a new way for people on relatively low incomes to become car-owners. A.T. Kearney forecasts that sales of cars in India and the rest of Asia (but excluding China) priced at $3,100-7,800 will reach 10.5m by 2020. Mr Tata thinks that the Nano could quite quickly sell between 500,000 and 1m a year in India alone.

For now, most of the top brass at the global car firms are just watching and waiting to see whether Tata can pull it off. The one exception is Carlos Ghosn. Renault has formed a joint venture with Bajaj, the Pune-based maker of motorcycles and auto-rickshaws, to develop a car with a cost base of about $2,500, which will make it slightly more expensive than the Nano. Mr Tata says the prospect of a near-rival from Renault-Bajaj only adds to his confidence: “Carlos was the only one in the industry who said the Nano could be done,” he says. “He was my secret motivator.”

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Kings of the road

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From The Economist print edition

Cheaper than four wheels, better than two feet

THE morning rush hour in the southern Indian city of Chennai (formerly Madras) is much like those in other big South Asian towns. A throng of mostly small cars hoot and jostle in a race against three-wheeled auto-rickshaws, dilapidated buses, fume-belching lorries and the odd bullock cart. But the real kings of these roads are the hordes of commuter motorcycles that swarm in and out of the choking traffic at daredevil speed.

Tom Tompietrasik

An eye on the competition

Asia is home to nearly 80% of the world's 315m motorcycles. About 45m of those are in India, the region's second-biggest fleet after China, with more than 100m. Sales of two-wheelers in India are running at about 7m a year, outstripping those of cars by nearly five to one. Not even one in a hundred Indians owns a car, but one in 20 owns a two-wheeler.

The TVS group has a foot in both the car industry, as one of India's most successful makers of automotive components, and the motorcycle business, through TVS Motor, the country's third-largest manufacturer of two-wheelers, with a 16% market share. Venu Srinivasan, the autocratic chairman of TVS, which is family-controlled, still sees plenty of potential for growth in the Indian motorcycle market. After a slight contraction last year because of tighter credit, business appears to be picking up again.

Among Mr Srinivasan's reasons for optimism are the much greater levels of ownership in other South Asian countries where income levels are higher, such as Malaysia, Thailand and Indonesia (where TVS has recently opened a factory that can build 300,000 units a year). In Thailand, for example, more than a quarter of the population owns a two-wheeler. Most developing countries find that when GDP per person reaches about $5,000, motorcycle sales begin to decline as people switch to cars. Thailand has nearly reached that point, but India is only about half-way there.

The dominance of two over four wheels is explained mostly by cost. Until the arrival of the Tata Nano the cheapest new car on sale in India had been the $5,000 Maruti 800, whereas the relatively small motorcycles that account for 85% of the Indian two-wheel market sell for $800-$1,500. Petrol in India is also expensive by developing-country standards. Even the lightweight Nano is unlikely to do better than 60 miles per gallon, whereas some of TVS's machines will do about 190mpg, says Mr Srinivasan. Maintenance, too, is much cheaper than for cars, and bikes can cope more easily both with poor roads and with congestion.

Since breaking with Suzuki, its joint-venture partner, in 2001, TVS has been the only big Indian motorcycle manufacturer to rely entirely on its own designs (the market leader is Hero Honda with a 47% share, and Kawasaki is a technology partner of second-placed Bajaj). As Mr Srinivasan sees it, parting from Suzuki has given TVS the freedom to design products that are suitable for the local market but also to build an export presence. By 2013, he says, 40% of TVS's sales will be outside India. He reckons that Indian motorcycles have an advantage over Chinese rivals in countries with poor infrastructure because they are more heavily built: "Our bikes cope with the worst roads and often have to carry three people. Chinese quality is not as good."

TVS's pristine factory at Hosur outside Bangalore (one of three in India) with its impressively disciplined workforce suggests that there is nothing wrong with the way the company makes its bikes. Keeping pace with the technology of its two heavyweight rivals may be more of a challenge. Mr Srinivasan concedes that TVS lost market share last year because some of its products were "not so good". Seven new bikes launched in September should help to fix that, but "there is no such thing as patriotic buying here, and Honda just keeps grinding away."

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The art of the possible

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From The Economist print edition

The question is not whether the world can cope with three billion cars—but how

UNTIL recently the biannual Beijing motor show was a bit of a backwater, a place where Chinese makers displayed their cheap but not very cheerful little cars and where the supposedly new offerings from the joint-venture manufacturers were in fact warmed-up Buicks and VWs from a previous generation. However, this year's Beijing show, the 10th, was a match for any of the industry's traditional showcases, not only for its crowds and glitz but also for the number of new cars launched, the size of the display stands and the head count of big wheels from the global firms. Yet there were clear warning signals too.

Foreigners flying into Beijing, Shanghai or Guangzhou are impressed by the wide expressways from the modern airport terminals to their downtown hotels. Yet the journey from the centre of Beijing to the show in nearby Shunyi told a different story. As the four-lane highway leaving the city narrowed to a single lane, the show-bound traffic came to a grinding halt. An hour or so later, outside the newly built exhibition halls, chaos reigned. With nowhere to stop, coaches dumped their passengers in the middle of the road where they had to negotiate giant potholes turned into ponds by rain falling from a leaden, polluted sky. It made the show's slogan—"Dream, harmony, new vision"—seem not just silly but almost mocking.

It is not much different in the other main emerging car-markets. In the big cities where the growing wealth is most concentrated, any pleasure in car ownership is counterbalanced by the increasing awfulness of the roads, the choking fumes and the near-impossibility of parking. In São Paulo the traffic is relatively disciplined, but the morning and evening rush hours have merged into one. In Mumbai people often allow two or three hours to get to a business meeting in another part of town. In both cities the spread of slums makes any kind of rational town planning impossible. In Moscow the excellent Stalin-era metro takes some of the strain, but the two big ring roads that encircle the town are constantly jammed.

Congestion, a mounting number of traffic accidents and worsening air pollution are the most obvious local problems associated with rapidly increasing car ownership. Given the will, government policies can ease some of them. In Brazil official encouragement of ethanol-powered engines has had some impact on air quality in the overcrowded São Paulo area. Both China and India hope to cut the emissions that cause smog and health problems by insisting that all new cars will have to meet the tough Euro IV standard within the next few years. Attitudes to safety in most developing countries are more casual than in the rich West, but China has been rigorously enforcing the wearing of seat belts, and consumers now expect at least a couple of airbags even in fairly basic vehicles.

Seizing up

Congestion is more intractable. In theory, better public transport systems, toll schemes, restrictions on registration permits and, where feasible, new flyovers and underpasses can all help to ease urban gridlock. Developing countries with cheap labour should also be able to find the resources to build plenty of new roads outside the towns. India, for instance, is in desperate need of better highways connecting big urban centres. The "expressway" that links Mumbai with Pune, an industrial city with a population of 6m, runs straight through crowded villages, with traffic sometimes slowing to walking speed. About 40% of India's road traffic is carried on just 2% of its roads, most of which leave much to be desired. As Ravi Kant of Tata Motors puts it: "India doesn't need fewer cars; it does need more roads."

What makes infrastructure investments in developing countries tricky is politics. Even in China, where agricultural land has been ruthlessly acquired for new roads, opposition is growing. In democracies the obstacles are even greater. Mr Kant says that in the five decades after independence India built almost no new roads. That changed when the pro-business Bharatiya Janata Party came to office in 1999. But since a Congress-led coalition took over in 2004, road-building has dropped off again.

Yet infrastructure problems are dwarfed by the likely effect of a huge increase in the worldwide number of cars on climate-changing carbon emissions and future oil prices. Research shows that $5,000 a year is the earnings threshold at which car-ownership takes off. On that basis, economists at the IMF have calculated that the number of cars worldwide will grow from 600m in 2005 to 2.9 billion in 2050. By 2030, they believe, China's car fleet will have overtaken America's (which itself will have increased by 60%), and by 2050 China will have almost as many cars as the entire world has today. India will be catching up fast, with a fleet of 367m, 45 times the number on its congested roads today.

Those cars will pump an immense quantity of greenhouse gases into the earth's atmosphere. According to the 2006 Stern Review on the economics of climate change, in 2000 cars were responsible for 6.3% of global CO_2 emissions. If car emissions were to grow in line with ownership, by 2050 they would raise total world emissions so much that scientists believe temperatures would rise by an alarming 3°C from pre-industrial levels.

In practice, it is inconceivable that car emissions will increase at this sort of pace. For one thing, the growth in the world's car fleet will put unremitting upward pressure on the price of petrol and diesel. Even though oil prices have more than halved since their mid-year peak of $150 a barrel, no carmaker is willing to bet that they will not rise again when the global economy recovers. Luckily for the car manufacturers, although higher fuel prices can make a difference to what kind of cars people buy and how much they use them, they do not dissuade them from buying cars altogether. Taxes on fuel at the pump in Britain and Germany are more than six times those in America, but levels of car ownership are only slightly lower—and might be similar if public transport in Europe were as bad and commuting distances as long as they are on the other side of the Atlantic.

For all the problems they bring, cars also confer large social and economic benefits. As the IMF economists note, "mass car ownership has historically been an integral component of the transition to an advanced economy. Workers can cover longer distances in their daily commutes, effectively increasing the size of the labour market and facilitating specialisation in production; consumers can purchase goods from shops farther from their homes, which results in greater competition in the retail sector; remote fishing villages can develop as tourist resorts with (mostly) positive effects on incomes and welfare; and so on." And at a more emotional level, most people simply like cars, even if the environmentalists disapprove.

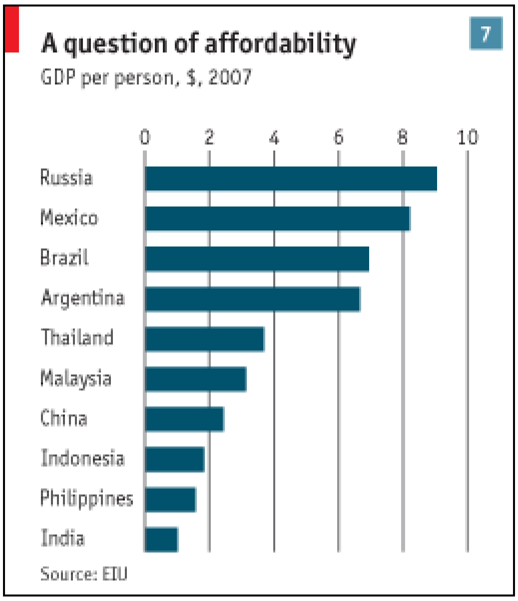
A green glow

But if that yearning is to be satisfied without destroying the planet, the cars themselves will have to change a great deal. Mr Ghosn of Renault-Nissan reckons that the industry has to develop vehicles with very low or zero emissions as quickly as resources and technology will allow. It is widely believed that the market for such cars for the foreseeable future will be confined to rich countries with well-organised environmental lobbies and politicians who want to establish green credentials—and indeed much of the pressure on the carmakers to reduce carbon emissions is coming from legislators in Europe and California. But two powerful forces are at work to ensure that emerging markets will get the new clean technologies sooner rather than later.

The first is the global nature of the car industry and its need for scale. Cars made by the big foreign-brand car firms in the BRICs are often tweaked for those markets, but they are no longer discontinued cast-offs from Europe, Japan, South Korea and America. Even those low-cost Renault Logans usually come with airbags, anti-lock brakes and air-conditioning because customers want them and because they are fairly cheap to provide. The well-equipped Hyundai i10s being made in Chennai for Indians differ only very slightly from those destined for export.

The second is that emerging markets often leapfrog old technologies. Many parts of the world that never got round to

building a traditional fixed-line telecoms infrastructure now have mobile networks offering widespread coverage and high-speed data transmission; and places that never had analogue television now enjoy multichannel digital satellite television.



Even though the internal combustion engine still has a lot of life left in it, the big carmakers around the world now broadly agree that the move away from mineral energy is unstoppable. Having long derided the hybrid Toyota Prius for its complexity and expense, just about every manufacturer is now planning to launch vehicles with hybrid powertrains within the next few years, taking advantage of rapidly improving battery technology. In particular, car companies think that the lightweight, fast-charging lithium-ion batteries used to power laptop computers and mobile phones are now robust enough to be fitted to road vehicles too.

One of the first of the next-generation hybrids will be Chevrolet's Volt, which is propelled by an electric motor that can be recharged from the mains. The Volt also has a small petrol engine that acts as a generator to extend the car's range. Such cars are now seen as essential to the industry's future; indeed for GM itself the Volt could prove to be a lifesaver. At first they will be more expensive than their conventional equivalents, but as production rises, helped along by favourable tax treatment, their price will quickly fall.

Electrifying prospects

Mr Ghosn thinks that the hybrids themselves may be only a bridging technology on the way to cars powered by batteries alone. His Renault-Nissan alliance, in partnership with NEC, an electronics giant, is pushing ahead with plans to launch all-electric vehicles that look and feel like conventional cars by 2010. Only fully electric cars, Mr Ghosn reckons, will allow the expected growth in car ownership without disastrous consequences for the planet.

Reuters

Generating interest in the Volt

Governments of developing countries have every interest in combating air pollution and substituting locally generated electric power for expensive imported oil. Alex Molinaroli of Johnson Controls, a big car-parts firm that specialises in battery technology, thinks that electric vehicles might be introduced on a large scale in China ahead of western Europe and America. He says China is well placed to introduce a new electric-car infrastructure partly because it still has relatively few petrol stations. "They don't have a legacy cost chasing them around," he explains.

Emerging-market manufacturers are also getting to work on the new cars. In September Tata Motors announced plans to launch an electric version of the Indica in Norway (where Tata has a technology partner) next year before bringing it back to India. In China DongFeng will start making a hybrid car under its own brand next year. Another Chinese carmaker, BYD, a subsidiary of one of the world's

biggest battery manufacturers, has developed a battery technology of its own that it claims has significant advantages over both lithium-ion and nickel-metal hydride (the type of battery used in the current Prius). It says its ferrous batteries are not only much cheaper but can also be recharged to 50% of their capacity within ten minutes. The world's canniest investor, Warren Buffett, recognises the technology's potential: his Berkshire Hathaway group has taken a 10% stake in BYD.

One factor that is critical to the success of this new breed of cars is the way the electricity to power them is generated. Carmakers say that even if it comes from coal-fired power stations, overall emissions could be half those of today's cars. But for Mr Ghosn's zero-emissions promise to be fulfilled, the electricity will have to come either from renewable sources or from nuclear or "clean-coal" power stations. However hard the car industry may try, there is little it can do about that.

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ANFAVEA (Brazilian trade body)

Society of Indian Automobile Manufacturers

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Offer to readers

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Economist.com BUSINESS

American carmakers

On the edge

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After the bank bail-out, it is now Detroit's carmakers who are pleading for help

Corbis

IF NOTHING else, the revelation by General Motors (GM) on November 7th that it is in danger of running out of cash before the end of the year has concentrated minds. The reaction within the embattled car industry, and in Washington, DC, has been the same: we knew it was bad, but we did not know it was that bad. Ford is in a similar position, although its cash should hold out for a few months longer.

As for Chrysler, the smallest and weakest of Detroit's Big Three, the precise state of its finances are harder to gauge because it is privately held. But the increasingly desperate attempts by Cerberus Capital Management, the private-equity firm that owns 80% of Chrysler, to offload some or all of it to another carmaker (GM said on November 7th that it had walked away from such a deal) suggest that its future as an independent entity is all but over.

What will happen next? The shareholders have been more or less wiped out, the credit markets are closed and neither GM nor Ford has any non-core assets that anyone wants to buy, with the possible exception of Ford's 33% stake in Mazda, a profitable Japanese carmaker. The North American car market should come back strongly in 2010 or 2011, but for all practical purposes, that is light-years away: North American sales are running at their lowest levels since the early 1980s, when the population was 50m smaller. There are just two broad options: either the federal government steps in to save Ford and GM (Chrysler is probably unsalvageable) or America's two biggest car firms must seek Chapter 11 bankruptcy protection.

In many ways, Chapter 11 was designed for just such a contingency. For all their present agonies, both Ford and GM have good long-term prospects. They have relatively healthy businesses in Europe and have been doing well in emerging markets, such as China, where there is vast potential.

They are also nearing the final stage of a lengthy and painful restructuring of their North American operations. Two million units of capacity have been stripped out; factories are being converted to produce more fuel-efficient cars; and a landmark deal with the United Auto Workers union in 2007 paved the way to cutting $1,000 of costs on every car they make from next year. "The river they are swimming across has been getting wider and deeper, but the pot of gold on the other side has been getting bigger as well," says David Cole of the Center for Automotive Research.

However, there is considerable scepticism both within the industry and among analysts as to whether Chapter 11 is a way forward for GM and Ford (though it may, some concede, be more appropriate for Chrysler). Mr Cole says that “it would kill them in the market”. The fear is that rather than give the firms a breathing space in which they could complete the restructuring of their operations and extract further concessions from the union, Chapter 11 would set off a downward spiral.

Consumer surveys that suggest that 80-90% of prospective customers would abandon the products of a carmaker that had filed for bankruptcy protection. When airlines went into Chapter 11, most of their passengers stuck with them, reasoning they would be at least be in business long enough for tickets bought for trips just a few weeks away to be honoured.

Cars are different. A car is the most expensive purchase many consumers make, and by buying a car they also enter into a long-term contract. Buyers expect their 60,000-mile warranties to be honoured, parts to be kept supplied and their dealers not to have disappeared. Used-car values are also a critical part of the deal. If the firm that made the car has gone bust, it becomes virtually unsellable secondhand.

A further reason why Chapter 11 might not work for the carmakers, says Mark Oline, an analyst at Fitch Ratings, is that they have very little scope for further cost-cutting. “They’re not being crushed by wage and benefit costs—it’s about revenue and products now,” he says. Bankruptcy would do nothing to speed up the introduction of vital new models.

Those arguments may have weighed heavily with both Barack Obama, the president-elect, and the Democrats in Congress, who are moving towards sanctioning a bail-out package. They have gained added force from estimates of the economic fallout that could follow bankruptcy. Rod Lache, an analyst at Deutsche Bank, believes it would imperil many of the component-makers in North America, which in turn would hit the foreign-owned “transplant” factories that make up the rest of America’s car industry.

Mr Cole’s firm has modelled a scenario in which Detroit’s production falls by 50%. He estimates that in the first year that would cost 2.5m jobs: 240,000 from the carmakers themselves; 795,000 from suppliers and 1.4m from other firms indirectly affected. The cost in transfer payments and lost taxes would exceed $100 billion over three years. Some of Mr Cole’s assumptions are likely to be too pessimistic, but his blood-curdling forecast and others like it have helped to convince legislators that the $50 billion of help that the carmakers are asking for would be cheap at the price.

How and when the rescue funds will arrive is less certain. Nancy Pelosi, the House speaker, has called for a bill giving the carmakers access to the $700 billion Troubled Asset Relief Programme (TARP) established to shore up failing banks. But Hank Paulson, the treasury secretary, said on November 12th that this was not what the TARP had been intended for. Some are calling for a repeat of the scheme used to bail out Chrysler in 1979. On that occasion, in exchange for a loan of $1.5 billion, the government received warrants that it eventually sold for a profit.

A “lame duck” session of Congress could be convened as early as next week to pass the necessary legislation. President Bush might still veto it, but is less likely to do so if Mr Obama backs the plan. His recent victory is at least one piece of luck to have come the carmakers’ way.

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Pharmaceuticals

Racing down the pyramid

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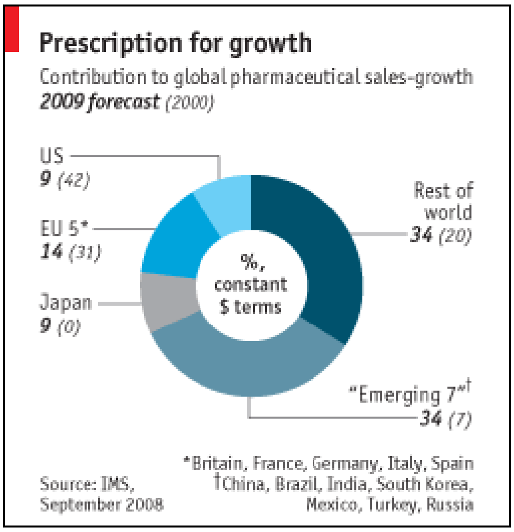
Big drugmakers' love affair with America is coming to an end

FOR many years America has been the heart and soul of the pharmaceuticals business. The adoption of price controls and government-run health systems in Europe, where the industry began, led many drugs firms to pitch their tents in the land of the free market. Keen to encourage innovation and suspicious of big government (until recently, anyway), America has allowed drugs companies to price their wares more or less as they please. As a result, over half of the leading firms' profits come from America alone.

So it might seem odd to suggest that the industry's future now lies in the developing world. Indeed, for years drugs firms resisted the trend, fashionable in other industries, towards pouring billions into emerging markets. They justified their stance by pointing to weak patent protection and low incomes in those markets. But now the industry has changed its mind.

When he took over as boss of Britain's GlaxoSmithKline (GSK) earlier this year, Andrew Witty declared that emerging markets would be at the heart of his growth strategy. GSK has since agreed a path-breaking licensing agreement with Aspen, a South African "branded generics" firm, and has just paid some $200m for Bristol Myers-Squibb's Egyptian operations. For its part Pfizer, the world's biggest pharmaceuticals firm, recently announced a restructuring that makes emerging markets a priority. Jean-Michel Halfon, who is in charge of that effort, says serving customers in developing countries is now "a business, not a charity."

Why the U-turn? The tremendous growth of drugs markets in the developing world proved too tempting to ignore. IMS, an industry consultancy, forecasts that sales in the biggest emerging markets will hit $300 billion by 2017, equal to today's sales in the top five European markets and America combined. Even before the latest downward lurch in prospects for rich economies, growth in those countries was expected to be much slower than in big emerging markets (see chart).



If growth is the carrot luring the drugs giants into emerging markets, the stick is the change in regulatory outlook in America from friendly to possibly frosty. The industry is concerned that Barack Obama, once in office, might allow cheap drugs to be imported from Canada or force Medicare, the government health-care system for the old and disabled, to negotiate big discounts with drugs firms. Peter Lawyer of Boston Consulting Group estimates that the latter reform alone could reduce the industry's American revenues by 3-10%. In fairness, any move by Mr Obama towards universal health-coverage could boost drugs sales by giving more people insurance, but the industry nevertheless worries about a squeeze on margins.

Hence the industry's zealous push into places like China and India. But if it is to succeed in emerging markets, its strategy and tactics will have to change. In the past, observes Loic Plantevin of Monitor, a management consultancy, Western drugs firms did not fare well because they often lazily "recycled" the products and marketing plans that worked in America for use in poorer countries.

But now he thinks firms are doing better. Some are offering products of particular relevance to developing countries, such as treatments for hepatitis B, or combination therapies, which are especially popular in India. Western firms have also dropped their traditional resistance to tiered pricing: Pfizer's Viagra, a drug for erectile dysfunction, and Merck's Gardasil, a vaccine against cervical cancer, were both introduced in India at a fraction of their American price. The health-care arm of Bayer, a German conglomerate, has seen its sales in emerging markets soar as it has included more locals in drugs trials and brought new pills

to market soon after launching them in America.

Some firms are going further, venturing beyond the familiar big cities to more difficult, but potentially more lucrative, territories. Mr Halfon says Pfizer has expanded in the past couple of years into over 130 Chinese cities. His firm has also set up a joint venture with Grameen Bank in Bangladesh to cultivate rural markets for basic drugs by developing “microinsurance” products. Mr Halfon is convinced there is plenty of money to be made among the underserved poor. He thinks the drugs market for those earning less than $3,000 a year is already worth $30 billion annually, and he expects this to increase to $60 billion-70 billion by 2012. Novartis, a Swiss rival, recently unveiled a pilot project to expand into rural India; the firm aims to reach 50m new customers by 2010.

Further evidence of emerging markets’ potential comes from the experience of Britain’s AstraZeneca in China. Unlike rivals, which focused on Shanghai and Beijing, its trailblazing marketers pushed into the country’s remote western provinces. The going was tough, but with little foreign competition the firm’s efforts paid off. It has just reported that during the third quarter, sales in mature markets grew by 2% compared with the same period a year ago, but increased by 35% in China—and by 18% in emerging markets overall. It seems that there is indeed a fortune at the bottom of the pyramid.

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Logistics

Failure to deliver

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DHL gives up on its American dream

MANY an ambitious, long-nurtured growth strategy will be abandoned during this rapidly worsening downturn. Bravely sticking to their original plans may ultimately make heroes of a few bosses, but in most boardrooms caution is now the watchword as new schemes are abandoned in favour of defending what is already profitable. DHL, the overnight-delivery arm of Deutsche Post World Net, a logistics conglomerate, is a case in point. On November 10th DHL said it would shut down its express-delivery service within America, with the loss of 9,500 jobs.

Five years ago DHL, which had been acquired by Deutsche Post in 2001, targeted the American market with much fanfare, eager to demonstrate that it was at least equal to the two delivery giants, FedEx and UPS. This was a crucial step in the campaign by Deutsche Post's boss at the time, Klaus Zumwinkel, to create a global "one-stop shop" for delivery. (The former McKinsey consultant stepped down in February this year after a raid on his home in Cologne, and on November 7th he was charged with tax evasion.)

From the start, DHL found the American market far tougher than Mr Zumwinkel was expecting; the recent savage decline in consumer spending was the last straw. FedEx and UPS were no cosy duopoly; they competed intensely, and fought DHL's every innovation. When DHL hired the US Postal Service (USPS) to do its domestic deliveries, a move that was popular with customers, FedEx and UPS immediately followed suit. More recently, the government-owned USPS has also become a formidable competitor in its own right, consolidating its number-three spot in the market. "The post office has got really good, and is now competing aggressively on price for the first time," says Hank Mullen of the Visibility Group, a transportation consultancy.

The quality of overnight delivery provided by FedEx, UPS and USPS within America is now remarkable, on time more than 95% of the time, says Mr Mullen. DHL was not helped by problems in its infrastructure that affected service quality, including culture clashes when integrating Airborne Express, an express-delivery airline it acquired, and its over-reliance on independent contractors. By the early part of this year, DHL was hatching a plan to outsource its domestic network to UPS, which raised some antitrust concerns. Some form of this proposed partnership may yet be agreed on, but DHL's decision to shut its main domestic facilities is expected to cost up to $3.9 billion, and to drive Deutsche Post into an overall loss in 2008.

Although its withdrawal ostensibly boosts FedEx, UPS and USPS, DHL had only around 4% of the domestic market. Moreover, it may now price more keenly to increase its share of the international express-delivery market, which usually has higher margins than domestic shipping. That said, the economic downturn is ensuring that this is a shippers' market, and any hopes that prices can be raised in today's climate look forlorn.

For at least 18 months small manufacturing firms and retailers have been suffering from weakening demand, says Brett Daberko of YRC, the leading road-based delivery company, which is increasingly up against FedEx and UPS in the road-freight market. The past few weeks have seen conditions in retailing worsen alarmingly, however. Bankruptcies are increasing: on November 10th Circuit City, an electronics retailer, became the latest big name to file for Chapter 11 protection from its creditors. Some economists now think that consumer spending in this quarter will be perhaps 5% lower than in the fourth quarter of 2007—a decline on a scale that nobody had thought possible.

FedEx and UPS have already announced sharp declines in profits. Their share prices have fallen by some 30% over the past year. Their one hope, in what everybody expects to be a miserable holiday-shopping season, is that the desire for bargains will cause many more consumers to shift to buying online. But even that may be a long shot, given that shares in Amazon are down sharply, too.

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Technology and advertising

Watching the watchers

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Television advertisements can work in fast-forward

BACK in the 1980s, marketers could be certain of reaching 90% of American households with an advertisement on prime-time network television. Now they would be lucky to reach a third. With hundreds of television channels and millions of websites to choose from, audiences have become fragmented. To make matters worse, the rise of digital video recorders (DVRs) such as the TiVo, which record programmes on a hard disk so that they can be watched at any time, also makes it easy to skip past the advertisements. So here, at last, is some good news for advertising folk: it is still possible to get your message across on television, even when a viewer has his finger on the fast-forward button.

The finding arises from an observation made by Adam Brasel and James Gips of the Carroll School of Management at Boston College in Massachusetts. They noticed that when people fast-forward a DVR they actually concentrate intensely on the screen, looking out for the end of the advertising break so that they can get back to their programme. This means they are probably paying more attention than they would if the advertisements were playing normally.

The researchers set up a series of experiments in which volunteers' eye-movements were tracked while they watched a nature documentary. Their study, published in the *Journal of Marketing*, showed that, even when the volunteers fast-forwarded ads, they could still be influenced by brand images that appeared for only a fraction of a second.

It all depends where the brand image is placed. A viewer who fast-forwards a DVR may see only one in 24 frames. This means some brand images appear on the screen for just a third of a second. But provided the brand image was in the centre of the screen, this was long enough for the volunteers to remember it. Eye-tracking showed viewers concentrated on the centre of the screen while fast-forwarding, probably because it is difficult to keep moving your eyes to take account of things around the edges.

With such a short exposure, and the sound disabled, the fast-forwarded ads that work best are those that contain little information and are simply intended to reinforce awareness of a brand, says Dr Brasel. The strength of such split-second ads was evaluated by inserting ads for two different brands of British chocolate bars, Aero and Flake, which are not sold in America and should therefore not have been familiar to the viewers. By a factor of two to one, those who were exposed to a brand image promoted in the centre of the screen during fast-forwarding ended up choosing that brand. So when you start to see TV ads in which the brand image takes centre stage, you will know why.

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Economist.com BUSINESS

Corporate restructuring

Centres of attention

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Companies may still have too many heads at headquarters

Illustration by Peter Schrank

DOWNSIZING is the undisputed global management trend of the moment. This week Nortel, a Canadian telecoms-equipment company, Britain's BT and DHL, a logistics giant owned by Germany's Deutsche Post World Net, were among a host of firms announcing thousands of job cuts. As well as pruning heads in business units, some chief executives are trimming their headquarters (HQs), too.

Nortel is a case in point. On November 10th the company said that it had lost $3.4 billion in its third quarter and was taking urgent steps to cut costs. These include shedding 1,300 jobs and handing over activities such as marketing and R&D, which were previously run from the centre, to business units. Among those leaving are its marketing and technology chiefs.

Like Nortel, many firms have grappled with the problem of creating the right relationship between the centre and the periphery. In the 1970s large and hyperactive HQs sprouted along with the rise of multinationals. In the 1990s the trend shifted to the minimalist centres favoured by private-equity owners, who just wanted them to ensure that operating managers hit their targets, stuck to agreed strategy and complied with laws and regulations. But over the past few years many corporate centres have been gradually expanding the scope of their activities again.

Of course, every company's situation is unique, and there is no single, perfect division of labour between HQs and other offices. But the chances are that the downturn will cause the pendulum to swing back towards minimalism. At the very least, it will force firms to determine exactly what their HQs contribute.

The amount of ignorance that still exists is striking: in a survey of 20 large British firms conducted earlier this year by Maxxim Consulting, only four chief executives knew how much their head offices cost to run, or how many people were in them. "This is a clear indication that there's some serious housekeeping to be done," says Claire Arnold, a co-founder of Maxxim.

One company that put its HQ under the microscope before the credit crunch worsened is Smiths Group, a British firm that produces medical equipment, security systems and other products. In December the firm brought in a new boss, Philip Bowman, who quickly concluded that the firm's London HQ was overbearing and overstaffed. Given that Smiths' business units had little in common, he says he saw no sense in having a large head office and has since pushed many of its activities back into the firm's different divisions.

As a result of these changes, the number of head-office staff has fallen from 100 to 50. Smiths has also taken the unusual step of detailing the cost of its HQ in its accounts: £35m ($70m) in the year to August. The idea, says Mr Bowman, is to create an extra incentive to drive the cost down. The London HQ's remaining employees have been moved from a run-down building on the outskirts of the city—which Mr Bowman describes as "an absolute rabbit warren"—to a modern, open-plan office in the centre. Smiths' boss reckons this will help break down the "silo mentality" that existed under the previous regime.

Some analysts who follow Nortel and Smiths think that the two companies may have bolstered their business units in order to make it easier to sell one or more of them. Perhaps, but there is little doubt that the previous set-ups were not working. Another company looking at its HQ is American International Group (AIG), a troubled insurer which this week received an even bigger bail-out from the American

government (see article). AIG, which plans to sell several divisions, has appointed a senior executive to rethink the organisation of its corporate centre. This will inevitably shrink—as will the HQs of many other ailing financial companies.

Still, quite how far to trim is a tricky question if your firm is not on the edge. “Companies must navigate this crisis with the right balance of skills at the centre,” says Fabrice Roghé of Boston Consulting Group. If they cut too deeply, they may not have the resources, say, to spot a strategic opportunity that could transform their fortunes. Ensuring that head office has the right number of heads in it is thus more vital—and more difficult—than ever.

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Asian casinos

Place your bets

Nov 13th 2008 | MACAU
From The Economist print edition

Casino operators have taken some big gambles. Who will clean up?

PUSH through the packed crowds in the smoke-filled haze of the main gambling hall of the old Lisboa, once Macau's flagship casino, or try to squeeze into a spot at a packed baccarat table at the Sands or its sister casino, the Venetian, now the most prominent property, and you would probably conclude that the gambling industry in Macau is thriving. Over the past year gambling revenues in the territory have increased by 27% to an all-time high (see chart). On November 10th Las Vegas Sands, owner of both the Sands and the Venetian, said revenues were up by two-thirds compared with a year earlier, and it had moved from an operating loss to a profit because of Macau's performance. And yet, as good as all that may seem, trouble is looming.

In the four years since the ending of the monopoly on gambling held by SJM Holdings, the Lisboa's parent, Macau has been transformed from a sleepy island into a legitimate rival to Las Vegas, with the same operators—Sands, MGM Mirage and Wynn Resorts—as the driving force. Growth, however, peaked in January and revenues have declined in the past two quarters.

Factory closings in southern China and the broader downturn in regional business have hit discretionary income. Worse still has been Beijing's tightening of the availability of travel visas for mainland residents, from twice a month to once a month in June and, more recently, to once every other month. Transit to Macau through Hong Kong has been blocked entirely. These restrictions have the greatest impact on the richest and highest-spending customers, and not surprisingly this segment has shown the biggest decline in business.

The slowdown comes just as many casino operators are entering the final stage of multibillion dollar investments in Macau that are transforming a stretch of seafront into an eastern version of the Las Vegas Strip. But most of the casinos are still under construction. Casino operators typically carry a lot of debt, the level of which peaks just as big building projects are completed—which, unfortunately for these companies, is now. The credit crunch, weakening economic conditions and tighter visa rules add up to a terrible confluence of bad news.

Moody's, a credit-rating agency, has a negative outlook on the entire Asian casino industry, and Macau in particular. Casino operators' share prices have collapsed. SJM, which went public in July after repeatedly cutting its offering price to entice a sceptical market, has seen its valuation cut in half. In the past year Wynn's share price has fallen by two-thirds, and those of Galaxy Entertainment, MGM Mirage and Sands by around 90%.

Sands' boss, Sheldon Adelson, has seen the value of his holdings fall by $34 billion. On November 10th Sands said that a long-planned expansion on Macau was being postponed indefinitely to preserve capital, having given warning on November 6th that it might default on its debt. Efforts are being made to raise capital, despite the forbidding environment. And in its struggles, Sands is hardly alone. Capital projects are being cut by every operator and, after years of desperately searching for labour, lay-offs have begun.

Some casino operators may have no alternative but to sell out to healthier rivals as part of a broad consolidation. In Hong Kong there are rumours that the Chinese government wants to force out the foreign operators and will relax the visa restrictions only as part of a reorganisation of ownership within Macau.

And yet, even in these grim times, there are some positive signs. Largely because of the Venetian, Macau

has become a conference destination and the place where people in Hong Kong and southern China go to see rock concerts and sport. Transport links get better by the week. And the casinos have a strong customer base.

Any desire the Chinese authorities may have to crack down on the casinos must surely be tempered by the possibility that the industry will merely move elsewhere, with the most likely candidate being Singapore, where Sands is in the midst of completing a vast new gambling project that is already fully funded. There are pots to be made in gambling. Someone with the money and nerve to stay in the game is going to make a fortune.

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Economist.com BUSINESS

Aviation in China

Chocks away

Nov 13th 2008 | ZHUHAI
From The Economist print edition

An air show highlights China's ambitions in aviation

"ZHUHAI is one of the world's most romantic cities," claims the airport website of the southern Chinese city, just along the coast from Macau. It is hardly Paris or Venice, but Zhuhai has a special place in the heart of China's aviation industry as the home of the country's biggest air show, held every two years, at which deals are done and home-grown technology is proudly displayed.

One of the stars of the 2008 show, even though it has yet to make its maiden flight, was the ARJ21, a locally developed 70-seat regional jet. Its first flight is due to take place on November 16th after several delays—which, in all fairness, are common throughout the industry. But the ARJ21 made headlines because its manufacturer, the Commercial Aircraft Corporation of China (CACC), announced that the aircraft-leasing arm of GE, an American conglomerate, had ordered five of the $30m jets, with the option to buy another 20. The first will be delivered in 2013.

Aircraft-leasing firms act as a buffer between airlines and aircraft manufacturers, buying and selling options on future aircraft with airlines and each other. GE has an interest in the ARJ21, as the supplier of its engines, and is expected to lease the aircraft to Chinese airlines. Even so, the deal was presented as a vote of confidence in the ARJ21, as the first Western order for the Chinese-built jet.

CACC says the aircraft is expected to obtain flight certification from American and Chinese authorities by 2010. But to sell its aircraft abroad, CACC will have to create a service and maintenance network, which will not be easy because of a shortage of suitably skilled staff. Within China, however, domestic airlines have already ordered over 200 ARJ21s. An import tax of 17% and a sales tax of 5% on aircraft weighing less than 25 tonnes has hampered sales of foreign jets, prompting manufacturers to stay out of the Chinese market (as has Canada's Bombardier) or set up local assembly lines (as has Embraer of Brazil).

CACC officials also provided more detail about the firm's plans to build a larger aircraft with 150 seats, putting it in the same class as the Airbus A320 and Boeing 737. Although China still lacks the technical expertise of Western manufacturers, CACC argues that the need for quieter, more fuel-efficient planes means that starting from scratch is not such a bad thing. The company plans to build the aircraft in conjunction with an international network of established component-suppliers—the model that is also used for the ARJ21, and is intended in part to reassure would-be buyers. It is sticking with its target date of 2020.

Many foreign analysts doubt that Western airlines will ever be prepared to buy Chinese aircraft. But, as in other fields, China is playing a long game.

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Face value

Portal of doom

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Yahoo!'s Jerry Yang, a nice person and a pioneer of the web, must go

AFP

NOBODY would have been surprised if he had pulled out. Hours before Jerry Yang of Yahoo!, one of the world's largest internet companies, was due to appear on the stage at an industry conference in San Francisco on November 5th, a big part of his firm's strategy disintegrated. But Mr Yang gamely turned up at the Web 2.0 Summit nevertheless, and in his gentle and polite way tried to explain how it had all gone so wrong. This has been a "pretty amazing year", he said with understatement. But he couldn't quite bring himself to admit that he had made a mistake in June 2007 by taking over as chief executive of the firm that he and his friend David Filo had founded in 1994, at which they had since held only the tongue-in-cheek titles of "chief Yahoos". Yet a mistake it clearly was, and it is time for Mr Yang and Yahoo!'s shareholders to say so.

At the time Mr Yang thought that he could, through sheer passion for his creation, revive the ailing company. He had been one of those who, during the dotcom depression, invited a Hollywood mogul, Terry Semel, to run Yahoo! and turn it into a media company. Both Mr Semel and Mr Yang, however, missed the significance of a new rival, Google, even though Messrs Yang and Filo had helped Google's two founders—all four had been graduate students at Stanford—to get started only a few years earlier.

Whereas Yahoo! saw itself as a "portal", or gateway, to media content on the web, Google gave web surfers a simple search box as their starting point. Whereas Yahoo! still thought of advertising as the equivalent of neon signs flashing on a web page, Google placed tiny text snippets in the margins of its search results, targeted precisely at the keywords of the search and charging advertisers only when people clicked. In time, Yahoo! understood that Google's way was the future and tried to catch up—first by hiring Google to supply search, then by firing Google and buying and building its own equivalent. But it was too late to catch up.

Mr Yang, who by nature is a non-confrontational sort of person, loyally supported Mr Semel until the very last moment, telling *The Economist* in May 2007 that he and the rest of the board were "in lockstep" behind their leader. One month later Mr Semel was out and, to some surprise, Mr Yang took his place. But things then began to go even more wrong.

The man whose big and lovable smile had once greeted millions of newcomers to the internet with “Jerry and David’s Guide to the World Wide Web” soon found himself testifying before Congress, with a grieving Chinese mother sitting behind him, about exactly what information Yahoo! had shared that had led to the jailing of two dissidents in China. Back at the office, Mr Yang had to deal with warring fiefs and bitter personal rivalries. Executives kept leaving, engineers were demoralised and innovative projects were put on hold.

Then, in February this year, Microsoft offered to buy Yahoo! for $33 a share. This could have put Mr Yang out of his misery. Microsoft, which owns a portal similar to Yahoo!’s and a search engine even further behind Google’s, wanted to combine forces to put up a better fight. Mr Yang said no. Several big shareholders revolted, but Mr Yang insisted that the price was too low. In the end, Microsoft gave up in frustration. “A lot of people have replayed that in their minds; I’m no exception,” Mr Yang said ruefully at the conference. With Yahoo!’s share price now at $12, he is eager to prove that he negotiated in good faith. At the right price, “we were willing to sell the company,” he said at the conference, but “they walked away.” He said that “I don’t have an ego about remaining independent” and that “both sides are to blame.” Perhaps.

But Mr Yang never offered a clear alternative to Microsoft’s proposal. He went back to his friends at Google, who obliged by offering an advertising alliance that might have given Yahoo! some extra cashflow to tide it over a restructuring. The drawback was that the deal would have had Google, already the dominant power in search advertising, placing its ads next to Yahoo!’s searches in America. Trustbusters were suspicious, even when Google offered to make concessions. That is why Google, thinking of its long-term antitrust strategy, abandoned the deal on November 5th, shortly before Mr Yang took to the stage. With a sad shrug, Mr Yang admitted that he was “disappointed”.

Now what? For years, there has been talk that Yahoo! and AOL, a portal owned by Time Warner, a media giant, should merge. They are similar, but it is hard to see how combining two long-in-the-tooth portals could somehow create an innovative Google killer. Both rely heavily on branded “display” advertising, which is suffering far more in the recession than the more precise search-related ads that are Google’s mainstay.

Annus horribilis

Mr Yang does not deserve the blame for all of this year’s woe. Bad things can happen to nice people. But he has never even given a convincing answer to the question of what Yahoo!’s strategy should be in an ideal world. To be a “starting point” for half a billion web surfers, Mr Yang likes to say. But how is that different from the old “portal” idea which stopped working long ago, or the search box that Google in effect controls?

Mr Yang told the conference audience that he wants Yahoo! to become a “platform company”, suggesting that outside developers should build applications to make Yahoo!’s services more useful. But Microsoft, Google, Facebook, Amazon, Salesforce.com and all other self-respecting technology firms nowadays want to become platforms, too. Why should Yahoo!, which has been less innovative, be the one to succeed? This argument is the one that pains Mr Yang the most. There is a “perception that we’re following,” he admitted, but “we do believe we’re innovating.” The audience of web entrepreneurs, many of them once inspired by Mr Yang’s example, let the matter drop. It is a bit sad to tell this old web hero to go. He must decide to do so himself.

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China's economy

Reflating the dragon

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From The Economist print edition

Can the world's fastest-growing economy avoid a sharp downturn?

AFP

WHEN Deng Xiaoping set China on the road of economic reforms in 1978, Western economists argued that "Only capitalism can save China." Exactly 30 years later, some pundits are claiming that "Only China can save capitalism." Most rich economies are now facing recession. But if China, the world's third-biggest economy, can manage to sustain reasonably robust growth, it will help to cushion global output. A massive stimulus package of 4 trillion yuan (nearly $600 billion) announced by the government on November 9th was therefore widely cheered at home and abroad. Will it be enough to re-stoke the dragon's fire?

After growing by an annual average of over 10% over the past five years, China's economy has suddenly cooled more quickly than expected. GDP growth slowed to 9% in the year to the third quarter, from 11.9% in 2007. That still sounds pretty impressive, but other indicators suggest weaker times ahead. Construction, steel demand, electricity consumption, car sales and air travel have all been falling in recent months. Industrial production grew by only 8.2% in the year to October, less than half its pace a year ago and its slowest for seven years. Share prices have slumped by 70% from their peak and house prices have started to drop. Property sales are running 40-50% lower than a year ago. Unsurprisingly, surveys show that consumer and business confidence is cracking.

China's slowdown only partly reflects weaker exports as the world economy sags. Some of it is home-grown, caused by a deliberate tightening of monetary policy to curb inflation and an overheated property market. Indeed, export growth has held up surprisingly well. In the first ten months of this year exports were 21% higher in dollar terms than a year ago, compared with growth of 26% in 2007. They have slowed more sharply in real terms, but were still up by 13% in the year to the third quarter.

Guangdong province, in southern China, has been hit hardest. Thousands of firms making shoes, toys and clothing have been forced to close this year, partly as a result of a new labour law that has lifted wage costs, as well as weaker foreign sales. According to local newspaper reports, half of China's toymakers and one-third of its shoe firms have disappeared this year. Yet toys and shoes now account for less than 5% of China's total exports. Exports of machinery and transport equipment (almost half of the total) are still rising at an annual rate of more than 20% in volume terms.

The doom and gloom in Guangdong may be overdone. Many small factories close every year as a result of

consolidation. Others have moved to cheaper parts of the country. The troubles of many firms in low-value sectors, such as toys and shoes, partly reflects China's success in moving up into higher-value industries, which has pushed up wages.

Across China, companies report that foreign orders have shrunk sharply over the past couple of months as the developed world has slipped into recession. Some economists reckon that next year China's exports may see no growth (in dollar terms) for the first time in more than 25 years. Imports are also slowing sharply, reflecting the high import content of many Chinese exports. Even so, UBS, a bank, forecasts that in 2009 net exports will be a negative drag on GDP growth. In 2007, net exports contributed almost three percentage points of the 12% increase in GDP.

Dismal export prospects will also depress manufacturing investment next year. Residential property construction is likely to continue to fall at least until mid-year, which, in turn, will reduce demand in industries such as steel and cement. However, China's housing bust is not as serious as those in many developed economies. Although too many luxury homes were built in some cities, there is no massive oversupply at the national level, and urbanisation and rising incomes will continue to support demand for housing.

One bright light amid the darkness is retail sales, which rose by 17% in real terms in the year to October. Some sectors, such as furniture and household electronics, are feeling the pinch from the property downturn, but overall spending is expected to remain brisk next year, thanks to rising incomes and households' low level of debt. Over the past year real incomes have risen by 10% in urban areas and 14% in the countryside. A fall in house prices will hurt Chinese consumers much less than their American counterparts, because Chinese households are not up to their necks in debt. Total household debt (including mortgages) amounts to only 13% of GDP, against 100% in America. During America's boom, it was easy to get a mortgage for 100% or more of the value of a home, but Chinese buyers have had to put down a minimum deposit of 30%.

Adding net exports, business investment, construction and consumption together, China's growth next year would probably drop to less than 6% without any government help—its slowest rate for almost two decades. Most countries would still be happy with such a figure, but it has become an article of faith in China that output needs to grow by at least 8% a year to create enough jobs for the millions of rural Chinese moving to cities. Growth of less than 8%, it is claimed, will lead to rising unemployment and social unrest.

In fact, the original estimate for China's required minimum rate of growth, which was made in the mid-1990s, was 7%, not 8%. And the correct figure is now probably lower, because the original estimate was based not only on the flood of people out of the countryside, but also on the number of new jobs that were needed to absorb massive lay-offs by state firms. In addition, the number of young people joining the labour force each year has fallen with the birth rate, and a spurt in rural incomes in recent years has encouraged some to stay on the farm rather than move to the city.

But even if the 8% rule is no longer based on sound economics, it clearly still carries a lot of weight with government officials. Over the past two months the government has announced a series of measures aimed at sustaining domestic demand. The People's Bank of China has cut interest rates three times and strict controls on bank lending have been scrapped. Measures to encourage home-buying have also been introduced: the minimum deposit on a mortgage has been cut from 30% to 20%, mortgage rates have been lowered and transaction taxes on homes reduced. A far more important boost, however, will come from the planned surge in infrastructure spending.

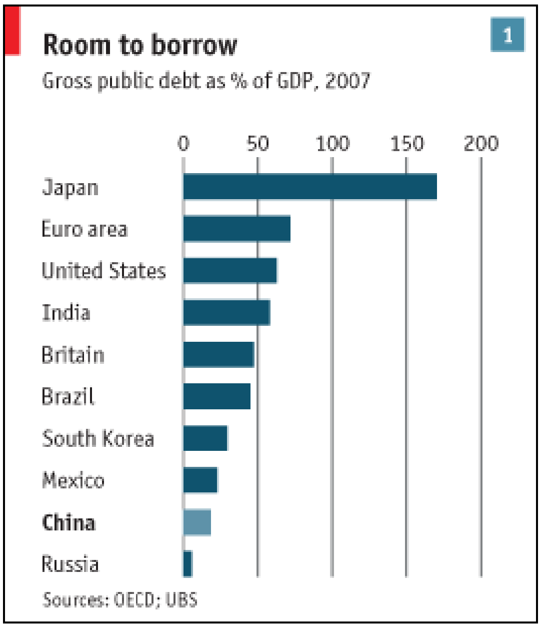
A New Deal, Chinese-style

The eye-popping 4 trillion yuan stimulus package unveiled by China's State Council this week is to be spent over the next two years. It amounts to 14% of this year's estimated GDP and, in dollar terms, is four times as big as America's fiscal stimulus earlier this year. The total increase in spending, if genuine, would surely represent the biggest two-year stimulus (outside wartime) by any government in history.

The package includes public works, social welfare and tax reform. The main spending areas are public housing for poor households; infrastructure projects such as railways, roads, airports and the power grid; speeding up rebuilding after the May earthquake; and increased spending on health and education. A reform of the VAT system will allow firms to deduct purchases of fixed assets, reducing companies' tax bills by an estimated 120 billion yuan (4% of 2007 industrial profits). This should encourage firms to upgrade their capital equipment. The government also plans to boost rural incomes by raising the

minimum purchase price of grain as well as increasing subsidies for farmers, and promises plumper social-security benefits for low-income groups.

The snag is that, as yet, there are no details about how exactly the money will be spent. It seems that the deteriorating economic situation panicked the government into rushing out its plans. Certainly previous prudence has left plenty of room for a stimulus: the budget surplus stands at 1-2% of GDP (depending on how you measure it) and total public-sector debt at less than 20% of GDP, one of the smallest of any large economy (see chart 1). In fact, not all the investment will be funded from the government's budget. A large chunk will be carried out by local government and state-owned enterprises. It will be mandated by the government, but financed by their own revenue, corporate bonds or bank lending.



Cynics have dismissed the package as much smaller than meets the eye. True, some of the infrastructure investment had already been planned, notably the extension of the rail network and rebuilding after the earthquake. In that sense, it is not really new money. But some of the money that was going to be spent over five years on railways has been brought forward. And the 4 trillion yuan excludes the tax cuts and transfer payments to farmers and the poor.

What matters for the economy is how much higher infrastructure spending will be next year compared with actual spending in 2007 or 2008. Rough estimates suggest that the true increase in investment may be between 5-7% of GDP over the two years to 2010: still an impressive figure.

But the most important aspect of the package is that the government seems to have sent a clear message that it will do whatever it takes to maintain growth at close to 8%. The bigger the slowdown, the bigger the likely stimulus. This signal, says Arthur Kroeber, an economist at Dragonomics, a research firm in Beijing, is more important than the exact amount of cash on offer. It could help to restore business and household confidence, and encourage firms to keep investing.

Some commentators have criticised the package for focusing too much on investment (which is already high as a share of GDP in China) rather than spurring consumption through income-tax cuts. But in a country like China, where the saving rate is high and confidence is failing, infrastructure investment is much better at boosting growth than tax cuts or welfare benefits, which would probably be saved rather than spent. In a developing economy infrastructure spending is also less likely to be wasteful than in a rich country like Japan, which built bridges to nowhere during the 1990s in an effort to keep the economy afloat. China plainly needs bridges and railways.

But in any case, in contrast to previous fiscal stimuli in China, this package does include some modest measures to boost consumption, such as raising the incomes of farmers and low-income urban households. Increased spending on health and education should also help to reduce households' worries about how to pay for these services, and so encourage them to save less and spend more.

In the long term China needs to do much more to boost consumption, but the immediate need is to prevent a hard landing. To the extent that the package boosts domestic demand, it could help deliver better-balanced growth. Unfortunately, the government has also increased tax rebates on exports, on which the economy remains far too dependent.

Déjà Hu?

China last adopted a big stimulus package during the Asian financial crisis, when it succeeded in holding annual GDP growth at almost 8%. However, the country now faces a much bigger external shock than it did then. So can it repeat the trick? Tao Wang, an economist with UBS in Beijing, believes it can. Not only is this stimulus package probably larger than that adopted during the Asian crisis, but, argues Ms Wang, the corporate and banking sectors are also in much better shape than ten years ago.

Reuters

The Asian financial crisis hit China just as it was making a painful economic adjustment after the bust of a credit boom in the mid-1990s. Huge over-

capacity and large losses forced the government to undertake a massive restructuring of state-owned firms. Investment and jobs were savagely cut at the same time as exports stumbled. In 1997-98 state firms made a net loss of almost 1% of GDP; in 2007 their combined profits were over 4% of GDP.

Keep growing and keep consuming

The banking sector, too, now looks much healthier. Ten years ago, after the credit binge, banks' non-performing loans hit 40-50% of their assets. Today the figure is around 6%, and their profits have soared in recent years. Chinese banks have also largely escaped the problems which have paralysed credit markets elsewhere.

Tight restrictions on bank lending over the past year have now been relaxed. But one risk is that with economic growth and corporate profits faltering, banks may be reluctant to increase their lending for fear of future bad loans. Loans to many property developers are likely to turn sour, but these amount to only 7% of total lending. Most industries still have relatively strong profit margins and low debts by historical standards. China is one of the few countries in the world where total bank lending has fallen relative to GDP over the past five years.

China still has one advantage over most other countries. If necessary, the state-controlled banking system can be directed to increase lending to firms. That would raise long-term concerns about the future quality of banks' assets, but in the short term it would help to keep the economy ticking. The importance of this, says Ms Wang, is that while fiscal stimulus can jump-start the economy, bank lending is the fuel needed to keep it going.

Any analysis of China's growth prospects is clouded by the widely held belief that the government smoothes its GDP numbers and always overstates growth during economic downturns. Chart 2 plots China's official growth rate against an alternative estimate calculated by Dragonomics from expenditure data (ie, investment, household spending and exports). This estimate shows much bigger swings than the politically smoothed official numbers.

China has experienced two major recessions in the past three decades. In 1989, the year of political protests and killings in Tiananmen Square, GDP is estimated to have really fallen by almost 2%, but reported GDP growth stayed above 4%. In 1998-99 Dragonomics reckons that the real growth rate fell below 5%, while reported growth dipped only slightly below 8%.

It is possible that reported GDP growth figures will once again be massaged if the economy continues to slide. But perhaps this time China can genuinely avoid a hard landing: the underlying economy, while far from perfect, is in better shape, and the government has more room to boost its spending.

The investment stimulus won't work its magic overnight; it takes time to get projects started. So GDP growth could well drop below 7% in the first half of next year as exports and housing investment weaken. But most economists think the stimulus package will be enough to keep growth at 7.5-8% for the year as a whole. If so, of the world's eight biggest economies, China will be the only one to enjoy any growth next year; most forecasters expect all the others to contract. Indeed, the IMF's latest forecast of 8.5% GDP growth implies that China will account for almost half of all the increase in world output next year.

The rising yuan

China's fiscal stimulus was announced less than a week before President Hu Jintao was due to arrive in Washington for the G20 summit of world leaders, which will discuss ways to revive global growth (see article). Normally at international meetings China is accused of two things: its economy is too dependent on exports, while domestic spending is too feeble; and the yuan is grossly undervalued. Mr Hu will now be able to argue that China is doing its best to support domestic demand.

However many foreign officials, including America's president-elect, still complain that China is holding down the yuan to keep its exports competitive. It is true that China seems to have abandoned its previous policy of allowing the yuan steadily to rise against the dollar: it has barely budged over the past four months. But since the dollar has strengthened dramatically of late, the yuan has surged against other currencies such as the euro, sterling and most emerging market currencies. Indeed, in trade-weighted terms, against a basket of currencies, it has risen by 12% over the past six months. Since July 2005, when China scrapped its fixed peg to the dollar, the yuan's trade-weighted value has risen by 20%, by far the biggest appreciation of any large economy (see chart 3). The strength of its exports suggests that the yuan may still be undervalued. But foreign governments can no longer accuse China of refusing to allow its currency to rise.

Although China's planned fiscal expansion is still vague, it promises, if it is implemented and it works, to save the economy from a hard landing. And if stronger domestic demand sucks in more imports of raw materials and infrastructure-building machinery, that is the best way China can help the rest of the world.

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Debt and deflation

Depressing times

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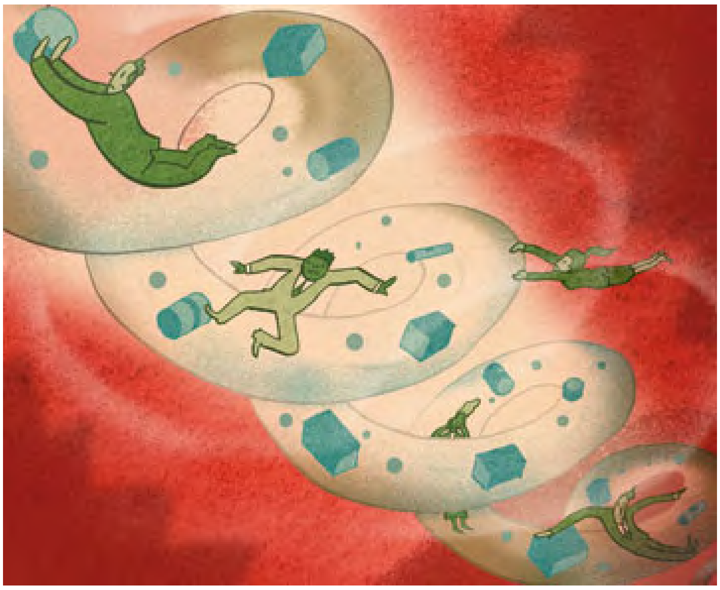
Are rich economies heading merely for a bout of falling prices, or for a 1930s-style deflationary spiral?

Illustration by S. Kambayashi



IN JUST a few brutal months, the prospects for the world economy have deteriorated with remarkable speed. Rich countries had seemed set for a shallow, muddle-through recession; now a much deeper slump is on the cards. In a sign of growing concern about American consumers, the Treasury and Federal Reserve on November 12th focused their rescue efforts on loans for cars and college and on credit cards. Central banks, recently so fearful of inflation, are now slashing interest rates to stop it falling too far. It will not be easy: deflation—annual falls in consumer prices—is increasingly likely next year. But recalling the 1930s, policymakers will be anxious to ensure that it does not take hold and turn crisis into catastrophe.

To consider the possibility of falling prices may seem odd when inflation is still uncomfortably high. In America, it reached 5.6% in July, the highest rate since 1991. In the same month inflation in the euro area surged to 4%. Britain's consumer-price inflation hit 5.2% in September, well above the government's target of 2%. This high inflation was mostly the result of the surge in commodity prices in the first half of the year. "Core" inflation, excluding food and energy costs, was far more stable.

But since the summer the commodity boom has turned to bust, changing the inflation outlook dramatically. The price of a barrel of crude oil has tumbled from a peak of $147 in July to below $60 in recent days. *The Economist*'s index of non-oil commodity prices has fallen by 40% since July. If raw-material prices remain at these lower levels, the year-on-year change in the retail prices of food and fuel will turn sharply negative in 2009.

That will add to other downward pressure on inflation. As economies fall deeper into recession and spending shrinks, firms will have to compete harder for sales by pricing their wares keenly. A glut of supply is evident in America's jobs market: the unemployment rate rose to 6.5% in October. A year earlier it was just 4.8%.

Falling food prices have quickly had an effect on inflation in China, which fell to 4% in October from a peak of 8.7% in February. In the rich world, a period of deflation seems more likely in America than in Europe. Crude-oil costs are a bigger slice of the prices American consumers pay for petrol: lower sales taxes and fuel duties mean swings in oil markets have a bigger effect on pump prices. Motor fuel also accounts for a

larger share of Americans' spending, so falling prices will depress inflation by more. Prices tend to be less "sticky": they respond more readily to economic conditions because markets are more flexible than in Europe. A stronger dollar will add to deflationary pressures in America while easing them elsewhere.

The year-on-year fall in oil prices is likely to be steepest in the third quarter next year, when the base will be this summer's peak. Economists at Goldman Sachs reckon that America's inflation rate will briefly turn negative at that point. Inflation in the euro area seems set to reach a low then too, even if prices do not actually fall. Speaking after the European Central Bank's (ECB) half-point cut in interest rates on November 6th, Jean-Claude Trichet, the bank's chief, allowed that inflation could fall well below the ECB's target ceiling of 2% next year. But such a drop would be "short-lived and therefore not relevant" to interest-rate decisions. The Bank of England sees deflation as more than just a remote risk. Its *Inflation Report*, published on November 12th, puts the spread of likely inflation rates at between -1% and 3% in two years' time. It is the first time the bank's fan chart, which projects where inflation is likely to lie nine times out of ten, has encompassed deflation.

A commodity-led fall in inflation ought to be good news for rich economies. It boosts consumers' real incomes and fattens firms' profit margins. Yet there is something pernicious about inflation falling too far, too fast. Because falling prices make debt more expensive, indebted households would be more anxious to pay off loans, even as other consumers were benefiting from a boost to their purchasing power. If deflation took hold, the gap in demand left by those fleeing debt would not be filled by cash-rich consumers, who tend to be less free-spending.

A deadly mix of falling prices and high leverage could foment a "debt-deflation" of the type first described by Irving Fisher, an American economist, in 1933. In this schema, debt-laden firms and consumers rush to repay loans as credit dries up. That hurts demand and leads to price cuts. The deflation in turn increases the real cost of debt. It also means that real interest rates can't be negative, and so are undesirably high. That spurs yet more repayment so that, in Fisher's words, the "liquidation defeats itself."

Fisher's theory is of more than just academic interest. Recent lending surveys by the Federal Reserve and the ECB showed a larger share of banks tightened their lending criteria in October than in July. Such is the concern in America that on November 12th regulators said they would scrutinise the dividend policies of banks that did not increase lending.

The surveys also revealed a reluctance to borrow, which tallies with signs of a collapse in spending. Foreign orders for German capital goods slumped by 14% in September, suggesting firms worldwide are cutting investment. Car sales in America and Europe are plummeting. American retailers, such as Neiman Marcus, J.C. Penney and Gap, reported double-digit falls in sales in the year to October. The retail data in Britain are grim too, which is a big worry for firms which have been through the private-equity mill and are loaded with debt. If sales do not respond soon to interest-rate cuts, some retailers may resort to deep discounts as Christmas approaches.

Bond markets expect consumer prices in America to fall by as much as 2½% over the next year, according to Mark Capleton, of the Royal Bank of Scotland. Inflation in the euro area is expected to be close to zero. When prices were climbing rapidly, central banks fretted that consumers' inflation expectations would rise in response. They will now be as keen to keep them from falling too far. That means interest rates in rich countries may soon fall to zero; some are already close (see article).

Deflation is not the only fear, however. Investors seem keen to hedge against all outcomes. "The options market tells us that inflation uncertainty has rocketed," says Mr Capleton. That reflects fears that policymakers, in their efforts to tackle deflation, will go too far the other way.

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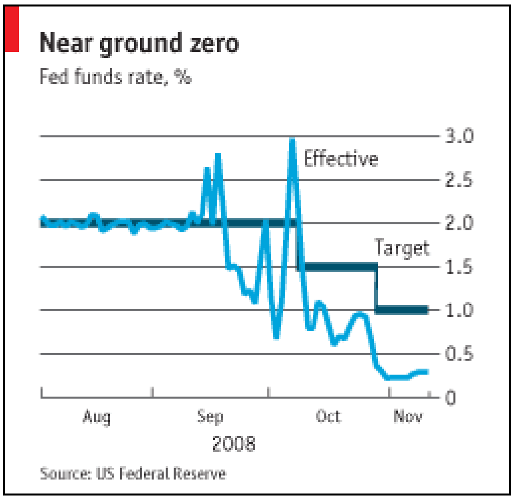
The Federal Reserve

Turning Japanese

Nov 13th 2008 | WASHINGTON, DC
From The Economist print edition

America's fed funds rate is, in effect, almost at zero



REMEMBER Japan's zero interest rates? America is almost there too. Since October 29th, the target for the federal funds rate has been at 1%, but the rate at which funds actually change hands, known as the "effective rate", has averaged around 0.25% (see chart).

The Federal Reserve does not always hits its target on the nose but the size of the gap is extraordinary. If it persists, any decision to lower the target further would be meaningless since it would not affect the rate banks actually pay.

Normally, the Fed keeps the funds rate on target by draining from or adding to the reserves that the banks hold with it. But the Fed has extended huge loans to banks and others to loosen up the credit markets, creating more reserves than it can drain. So to keep the fed funds rate up, it has, since November 6th, been paying interest on excess reserves at the full target rate of 1%.

Even so, the effective rate remains stubbornly low. One explanation is that the quasi-governmental home-loan banks and mortgage agencies have been lending to banks at rock-bottom rates. Another is that there are so few transactions that the effective rate has become an imprecise gauge.

The irony is that, were the gap to disappear, there would be a de facto tightening of monetary policy. On the other hand, if the effective rate remains near zero, the Fed will have to turn to more unconventional means of stimulating growth. Michael Feroli of JPMorgan Chase proposes outright purchases of mortgage-backed securities—another faint echo of Japan.

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Economist.com FINANCE & ECONOMICS

AIG

Cheque mate

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From The Economist print edition

How AIG got Uncle Sam over a barrel

JUST how concerned should American taxpayers be about American International Group (AIG), the insurance company brought to its knees by its escapades in the credit-derivatives market? On November 10th a revised rescue package was announced, comprising $153 billion of capital injections and loans. That is the largest bail-out for any firm, anywhere, during the crisis. Is the government being, as AIG's new chairman says, "very, very smart", or has it been taken for one of the most expensive rides in corporate history?

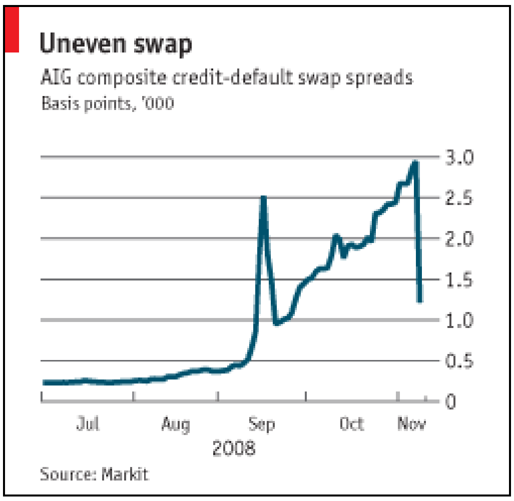
Even on September 16th, when the state first intervened, AIG was a controversial candidate for assistance. Its insurance businesses are ring-fenced by local regulators and individually capitalised, precisely so they can survive a collapse of the holding company. A bankruptcy was avoided only because of the size of the holding company's book of toxic credit derivatives, which senior executives barely understood. These left AIG so intertwined with other financial firms that its failure was judged by the Federal Reserve and Treasury to endanger the financial system.

Whether that judgment was right remains unknowable. But it is now clear that the original plan was flawed. That may be understandable: panic was in the air, AIG faced crippling collateral calls and Lehman Brothers had just folded. And the authorities lacked the wide powers granted by the Troubled Asset Relief Programme (TARP) approved by Congress in October. Unorthodox options, such as splitting the systemically threatening credit derivatives from AIG, were not under discussion.

As a result, the original plan looked a lot like the traditional remedy for a liquidity crisis at a solvent bank. The Fed offered a two-year, $85 billion loan. AIG would pay a penal interest rate and cede to the state an equity stake of just under 80%. But as collateral calls mounted on the credit derivatives, and AIG admitted to new problems, it became plain that the loan was too small. It was also too expensive: in the first year it would have cost almost as much as AIG's profits in 2006, its best year ever.

Meanwhile the chances of AIG being able to repay the loan also shrank. In the second quarter, it had only $59 billion of core equity capital (defined here as book equity less goodwill, tax assets and stock ceded to the state). By the third quarter, more losses had cut this to a meagre $23 billion. Worse, much if not all of AIG's capital sits "stranded" in the ring-fenced insurance units. That makes it hard to funnel it up to a holding company that is otherwise almost certainly insolvent.

The original solution was to sell the insurance operations to raise cash, but with AIG's competitors also reeling, this looked less and less realistic. The alternative, of AIG tapping credit markets to repay the state, became ridiculous by early November. AIG's own credit spreads implied that the company was headed for default (see chart). Prospects of even rolling over the $64 billion of non-government borrowing due to mature by 2011 became increasingly bleak.



That forced the hand of the authorities. In one sense the new package does what, with the benefit of hindsight, should have happened all along. The Fed will provide $53 billion of funding for two vehicles which will, in effect, assume AIG's most toxic credit derivatives and mortgage-backed securities. These positions have been marked to fairly conservative levels.

In an alternative universe the government could then walk away, confident that it had dealt with the worst of the systemically important credit derivatives and that the insurance operations remained safely ring-fenced. But in the real world the state is now the biggest lender

to AIG, which has drawn down the bulk of the original $85 billion facility. AIG has Uncle Sam in a bind. As a result, the Treasury, through the TARP, has been forced to recapitalise the insurer by purchasing $40 billion of preference shares. Despite this its economic stake in the firm will remain just below 80%. The Fed will also maintain a loan facility, on more generous terms, of $60 billion. And if AIG struggles to refinance its debts, it is quite possible that the state will provide a formal guarantee.

The Treasury has secured crowd-pleasing concessions; for example limits on executives' bonus payments. But the real question is whether the preference shares are safe. AIG has a trillion-dollar balance-sheet. There is now a thin buffer of core equity between the taxpayer's preference shares and any further losses. The hope is still that as markets recover, AIG can sell the crown jewels of its insurance business at a premium to book value. That may well take years. Plenty of time to reflect on how an offer of a temporary loan, to a company that barely made the list of systemically vital firms, spiralled into one of the biggest corporate bail-outs ever.

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Buttonwood

An appetising spread

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The corporate-bond market is discounting very bad news

Illustration by S. Kambayashi

SHERLOCK HOLMES might have called it "the curious case of the corporate-bond market". Most commentators agree that bonds issued by companies offer spreads over treasuries that more than compensate for the risk that the issuer might default. But few investors are tempted to buy.

The reason has more to do with the problems of investors than the deteriorating finances of issuers. About 20 years ago, the main buyers of corporate debt were pension funds and insurance companies. They would buy the bonds of creditworthy, investment-grade companies and then hold them till maturity. It made for a reliable-but-dull asset class.

The use of leverage, or borrowed money, changed that. All that hedge funds, and other speculative investors, needed to do was to buy bonds on yields greater than their cost of finance. The difference, or carry, would be the main source of return; if the bonds rose in price as well, so much the better.

Indeed, by early 2007 corporate-bond spreads were ridiculously low, offering a return that failed to compensate investors for the likely level of defaults. Borrowers rode roughshod over investors. In that year, TDC, a Danish telecoms group, was able to cut the interest rate it had agreed to pay lenders only a year earlier; "covenant-lite" loans, which imposed few restrictions on borrowers, were all the rage.

The market has now swung to the other extreme. According to Moody's, a rating agency, investment-grade firms are now paying double the spread over government bonds that speculative, or junk, issuers were paying back in June 2007.

Junk issuers are now paying around 15 percentage points more than treasuries, compared with just two-and-a-half points in June last year. Investment-grade firms are now paying a spread of more than five percentage points, compared with less than one point in February 2007.

That might seem unsurprising, given the deteriorating economic outlook and the defaults we have already seen in the financial sector. But John Lonski, an economist at Moody's, reckons that spreads are signalling the expectation of default levels not seen since the Depression. And Stephen Dulake of JPMorgan calculates that spreads are more than wide enough to compensate for the impact of a 2.5% fall in the American economy next year.

To give an idea of the scale, the default rate in 1933 was 15.4%; in the early 1990s recession, it reached 12%. These are still far in the distance. Over the year to the end of October, only 2.9% of American junk bonds had defaulted, according to Standard & Poor's (S&P), a rating agency. It expects the rate will rise to 7.6% by September 2009 (or 9.6% if the economy tumbles).

So why are investors not buying? The total return of investors is dependent not just on the default rate, but on the recovery rate when companies collapse; in other words, how much investors get paid back. The standard assumption is that the recovery rate will be 40%, but with Lehman Brothers and Iceland's banks it looks as if some investors will get back less than ten cents on the dollar. High spreads could reflect fears of low recovery rates.

A second cause may be potential indigestion. In Europe S&P reckons that some $2.1 trillion of corporate debt will mature between the last quarter of 2008 and the end of 2011. With governments also likely to tap the debt markets heavily, investors may be worried about the prospect of their portfolios being

weighed down by fixed-income assets.

But the biggest question-mark is over those leveraged investors. Some hedge funds have been forced to sell bonds to raise cash so they can repay investors who are unhappy with their returns this year. Others have been forced to cut back because of restrictions imposed by their prime brokers, their main source of finance. And even those that are able to borrow money are finding it more expensive; Barclays Capital reckons that funding costs have risen by more than a percentage point since last year.

For such investors, corporate bonds may not be all that cheap once all the costs have been taken into account. In addition, there is always the risk that bond prices could fall (and spreads could widen) further in the short-term.

However, that still creates an opportunity for old-fashioned investors who do not rely on borrowed money and who can buy on the basis of a five-year time horizon. One such investor is Kathleen Gaffney, a portfolio manager at Loomis Sayles, a fund-management group. “We have moved beyond fear of financial Armageddon to thinking about the steps to recovery,” she says. But for the moment Ms Gaffney is the exception, not the rule.

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Japan's economy

A tunnel, no light

Nov 13th 2008 | TOKYO
From The Economist print edition

Japan finds itself more vulnerable than it had thought to the global chill

Bloomberg

IN THE race to lower forecasts of economic growth and company profits, Japan is near the front. On November 6th Toyota, a paragon among Japanese manufacturers, said that it expected a stronger yen, higher input prices and falling worldwide demand to mean a 74% drop in net profits in the financial year that began in April—an incident that Japanese swiftly dubbed the "Toyota shock". The pain is spreading fast: in the first three weeks of October, Japan's exports were a tenth lower than a year ago—a deep concern for an economy driven by sales abroad. In late October Japanese share prices reached their lowest point since 1982. Measured by price/earnings ratios, they seemed cheap last month. But now that earnings are hastily being revised downward—the latest survey suggests companies expect profits to fall by 26% this financial year alone—they no longer seem such a steal. A growing number of economists see no recovery for Japan until 2010. The IMF expects Japan's economy to shrink by 0.2% in 2009.

Worsening global conditions are being driven by massive deleveraging. That Japan should be part of this appears, on the face of it, unfair. The country's banks, recovering from the bursting of Japan's own bubble in the 1990s, have not had time to commit the follies of their American and European counterparts. Companies have spent a decade shedding debt, and households have been huge savers.

Yet Japan's glut of savings has led to chronic overinvestment, notably in export industries, partly thanks to managers who are little accountable to shareholders. Betting on exports was fine so long as global demand was brisk. Now, manufacturing has slumped: the *Oriental Economist*, a newsletter, points out that volumes are a mere 5% or so above 1991 levels (see chart). The result is excess capacity and inventories. So, says Robert Madsen of the Massachusetts Institute of Technology, excess capacity coupled with an over-reliance on exports, particularly to the United States, actually makes Japan "a leveraged play" on overseas growth.

The question now is whether the Bank of Japan will be forced to reinstate measures first used to deal with post-bubble deflation: keeping short-term interest rates at zero and flooding banks with excess liquidity in a process known as "quantitative easing". At the end of October the central bank cut rates for the first time in seven years, from 0.5% to 0.3%, and another cut looks likely before long. Meanwhile, the Bank of Japan will start paying interest on banks' surplus reserves—in effect, allowing quantitative easing to begin before interest rates are again at zero.

The government is planning to ease accounting rules for banks that count rapidly depreciated shareholdings as capital, and to provide loan guarantees for small and medium-sized businesses. But the chief thrust of policy should be fiscal spending. The ruling coalition has announced a fiscal stimulus of about 1.4% of GDP,

mainly via tax cuts. That is unlikely to be enough, but Japan's political system, in its own crisis, is unable to act boldly at a time when the national debt is already sky-high.

In the long run, what Japan needs is as clear as it has always been: less dependence on export-led manufacturers, more productive and internationally minded service companies, and a more flexible workforce that welcomes women, older workers and immigrants. If the "Toyota shock" has helped lend these matters a sense of urgency, then something will have been accomplished—but do not hold your breath. For the time being, where the world economy goes, so goes Japan.

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Banco Santander

Pack behaviour

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From The Economist print edition

Spain's biggest bank raises capital, pressuring others to follow

BANCO SANTANDER is more used to being predator than prey. Spain's largest bank, and Europe's biggest after HSBC, has hunted down plenty of institutions since the credit crisis began. The tastiest catch was Banco Real in Brazil, once part of ABN AMRO, but it has also snapped up Alliance & Leicester and bits of Bradford & Bingley in Britain, plus Sovereign Bancorp, an American bank. Yet even Santander has vulnerabilities.

On November 10th the bank surprised investors by announcing a €7.2 billion ($9.2 billion) rights issue and targeting a new core tier-one capital ratio of 7%, up from 6.3%. (The actual buffer will be higher still, thanks to the extra provisions that Santander set aside when times were good.) The decision came just two weeks after its bosses ruled out going to the market.

What happened? Santander faces new headwinds, thanks to sharp downturns in its mature markets and worsening sentiment about emerging economies. Raising money by selling non-core assets is difficult. All those acquisitions will also erode capital. Even so, the bank claims that it was comfortable with the capital it had; but it argues that it had to catch up with other banks, which had beefed up their core-capital ratios with government money (the European average is now 7.5%). The alternative was to be punished by skittish markets.

Others will now be pressed to raise money too. Intesa Sanpaolo of Italy cut its dividend on November 11th; eyes are on other Italian and Spanish banks, as well as the French and Irish banks, and Standard Chartered, an emerging-markets lender. Demanding uniformity may not be fair: banks run different risks, says Arturo de Frias of Dresdner Kleinwort, so need different levels of capital. But as every hunted animal knows, it is not how fast you run that counts, but whether you are slower than everyone else.

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Economist.com FINANCE & ECONOMICS

Credit-rating agencies

Negative outlook

Nov 13th 2008
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Europe misfires in its attack on the rating agencies

IN AN age of e-mail every industry is likely to have a Henry Blodget moment. The one for rating agencies came in mid-October, when a rash of embarrassing correspondence emerged. Among them was the following exchange between two analysts: “That deal is ridiculous. We should not be rating it.” Back came his colleague’s answer: “We rate every deal…it could be structured by cows and we would rate it.”

The conversation was more than mortifying. It cut to a central conflict bedevilling the industry: although ratings are relied on by investors and regulators as impartial measures, the rating agencies are paid by those they rate for their judgments.

With their marks of approval stamped all over the most toxic assets poisoning the financial system, they were quickly blamed for helping cause the credit crunch. Some of that criticism has ebbed, but among those still carrying a cudgel is Charlie McCreevy, the European internal-market commissioner. On November 12th he released a draft law to regulate them and end what he acidly called their “charmed existence”.

Some of Mr McCreevy’s rules on minimising conflicts of interest are sensible. But some are wide of the mark. Regulators in each European country will be given the power to meddle with ratings that they do not like—the downgrade of an important bank or flag-carrying airline, for instance. If rating agencies can be too optimistic, imagine how much more so governments would be about their national treasures.

Moreover, by tightening up registration and regulation of the rating agencies, Mr McCreevy may be moving in the wrong direction. Already they have too much power and influence; they get access to information that ordinary investors and stockmarket analysts do not; they also have a special place in the financial system because their ratings are integral to the regulation of financial firms such as banks, insurers and pension funds.

This has created an oligopoly that lulls users of their ratings into a false sense of security and spreads moral hazard: investors tend to rely on the ratings rather than making credit judgments of their own. Yet the privileges come without commensurate responsibility. When rating agencies get things wrong they rely on a defence of free speech, saying that their ratings were merely the expression of an opinion.

Tying them even more tightly into the regulatory system is likely only to exacerbate these contradictions by raising barriers to new entrants and making the rating agencies appear even less fallible. Much better would have been less regulation, more competition and a requirement that bond issuers release any information they provide to the rating agencies to the public. Then everyone would have had a chance to get what they all say they want: investors who think for themselves.

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Specialist lenders

Home run

Nov 13th 2008
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Serving subprime borrowers requires specialist skills

THE word "subprime" may now send shudders down bankers' spines. But a number of listed lenders that specialise in making loans to people with poor or no credit histories are proving that money can be made from even the riskiest customers. The way they operate may explain why mainstream lenders find it hard to descend the credit ladder.

Last month, Provident Financial, a British lender to what it calls "non-standard" borrowers, and International Personal Finance (IPF), a spin-off from Provident that operates in eastern Europe and Mexico, both issued relatively upbeat trading statements. Both reported growth in customer numbers, as other lenders have drawn in their horns. More impressively, they also said that customer arrears had remained stable.

Specialist lenders are not immune to the effects of the crisis, of course. Funding concerns have roiled the share price of Cattles, another British lender: it is seeking a banking licence so that it can gather deposits. The severity of the economic downturn will set a stern test of lenders' credit management. But they have a number of things in their favour.

One is the frequency of their contact with customers. Both Provident Financial and IPF collect loan payments from borrowers' homes each week, giving them instant information if a customer is struggling. Another is the incentive scheme they operate for their agents, the bulk of whose earnings is based on how much they collect. "It is better for agents to lend less and collect more than to lend more and collect less," says Christopher Rodrigues, IPF's chairman. IPF's employees habitually offer less money to borrowers than the firm's automated credit system says they can.

Mainstream lenders cannot easily follow this approach. IPF and Provident loan out smaller sums of money (the equivalent of a few hundred dollars, typically) at shorter durations and higher rates. Banks do not have teams of agents to knock on people's doors. Specialists make a virtue of lending to people who cannot get credit elsewhere, because that means they are not loaded up with debt. But that is the point. The shift in Cattles' business model over the past few years, to bigger loans and remote servicing, has increased its risk profile, says Robert Self, an analyst at Credit Suisse. When serving subprime borrowers, acting like a bank can be a hindrance, not a help.

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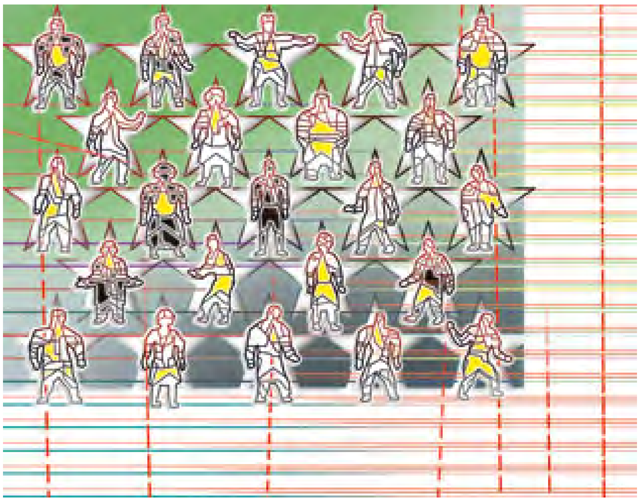
Economics focus

Race and red tape

Nov 13th 2008
From The Economist print edition

One unsung benefit of financial deregulation is greater colour-blindness

Illustration by Jac Depczyk



THIS is a bad moment for financial deregulation in America and a good one for race relations. Yet might the two be connected? New research* by a trio of academics at Brown University shows that when American states liberalised their uncompetitive banking markets between the mid-1970s and 1994, one of the little-noticed side effects was a reduced wage gap between blacks and whites.

It has been widely documented that black workers in America earn less than their white peers, partly because the average black worker has less education and experience than his white counterpart. But even after stripping out all observable differences between workers, there remains an unexplained shortfall in the wages of black workers compared with white ones. Economists call this the "racial wage gap".

At least some of this appears to be because of bias. A recent paper† has documented that American firms are one-and-a-half times as likely to interview a person they think is white than one they think is black, even if both have identical qualifications. To reduce this bias, there are common responses such as affirmative-action policies and education. Since Gary Becker, a Nobel-prize winning economist, wrote "The Economics of Discrimination" in 1957, the role of competition has also been central to economists' thinking about how to ease discrimination at work.

Bias beware

Mr Becker argued that because discrimination arising from the prejudices of employers was economically inefficient, it would be harder to get away with the more competition there was. For example, a biased monopolist might hire a more expensive white worker even though a cheaper black one was available and up to the job. But if another firm entered the market, it could produce its goods more cheaply by hiring the black worker that the monopolist had turned down. By discriminating less, it could undercut its blinkered rival. Mr Becker did not argue that competition would get rid of bias or even necessarily reduce it. Rather, he argued that competition could greatly soften the economic effects of a given amount of bias on the part of employers. His model also implied that competition would have a greater effect where the existing degree of bias was greatest.

The researchers at Brown set out to test these ideas using the deregulation of the American banking industry—a process that had increased competition, but had nothing to do with the pre-existing levels of black and white pay. Before the mid-1970s most American states had laws preventing banks incorporated

in one place from opening branches in other states (and sometimes even in other cities). One consequence of this was scant competition and a highly localised banking industry, with many businesses or would-be entrepreneurs having access to only one bank. From then onwards, though, a combination of technological and legal changes increased competition in the industry. For example, the invention of the ATM (and a court ruling that ATMs were not branches) extended the reach of banks beyond their narrowly defined domains of operation. Over time, state after state removed geographic restrictions on banks' operations.

The consequences, as has been widely documented, were dramatic from a business point of view. Increased competition between banks led to lower overheads and lower interest rates on loans. People who wanted to start businesses found it easier to obtain financing. As states deregulated banks, they saw a spurt in the number of start-ups.

The proliferation of new firms produced more intense competition in all parts of the economy, not just the banking industry. Using the tide of bank deregulation to demarcate periods of higher and lower competition, the researchers were able to identify whether this made a difference to the racial wage gap. But first, they needed to compare the degree of pre-existing racial bias across states. They did so by contrasting actual rates of interracial marriage with what would result if people were randomly matched to partners; a bigger difference suggested (albeit crudely) the degree of racial bias. They then divided states into those above and below the median level of racial bias.

In keeping with the theoretical predictions of Becker and others, they found that the black-white wage gap declined the most in states with an initially high degree of racial bias after they deregulated their finance industry (and benefited from a surge of business start-ups). For high-bias states, their results suggested that about 22% of the racial gap had been "competed away". None of this seems to have been delivered through explicitly preferential lending to blacks; rather, black workers reported more hours of work and higher wages than before deregulation. The researchers found little change in states with a low degree of racial bias before deregulation.

The empirical evidence suggests that competition by itself is unable to wipe out racial discrimination. As the early theory pointed out, competition does not help reduce bias if the desire to discriminate comes from consumers or workers; it only limits the ability of biased owners to act on their prejudices. Changing attitudes takes longer, and notwithstanding Barack Obama's election victory, there is still some way to go. As the future president moves to tighten the rules governing American finance, as he surely will in response to the crisis, he would do well to remember the unexpected benefits that financial deregulation has brought to the economy.

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* Ross Levine, Alexey Levkov and Yona Rubinstein. "Racial Discrimination and Competition". NBER Working Paper No. 14273, August 2008. http://papers.nber.org/papers/w14273

†Marianne Bertrand and Sendhil Mullainathan. "Are Emily and Greg More Employable than Lakisha and Jamal? A Field Experiment on Labor Market Discrimination". http://www.economics.harvard.edu/faculty/mullainathan/files/emilygreg.pdf

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Minerals

How rocks evolve

Nov 13th 2008
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It is not just living organisms that evolve. Minerals do too, and much of their diversity has arisen in tandem with the evolution of life

Alamy

EVOLUTION has come a long way since Charles Darwin's time. Today it is not only animals and plants that are seen as having evolved over time, but also things that involve the hand of humans, like architecture, music, car design and even governments. Now rocks, too, seem to be showing evolutionary characteristics.

Rocks are made from minerals, which like all matter are composed of individual chemical elements. What makes minerals special is the way that the atoms of those elements are arranged in lattices which create unique crystalline structures and shapes. Today more than 4,000 different minerals can be found on Earth. When the planet began to be formed, however, few existed.

Curious as to how this great variety came about, Robert Hazen of the Carnegie Institution in Washington, DC, and a team of colleagues set out on their own voyage of discovery. Their study, just published in *American Mineralogist*, explores the history of minerals by identifying how much of the diversity was created by the rocks alone and how much of it was created by the evolution of life.

Before the formation of the sun and planets, all the chemical elements found on the periodic table were floating around in the primordial dust of the Solar System. Some elements were more common than others, but everything from argon to zinc was there. Minerals, however, were almost entirely absent. Only a handful, like diamonds and olivine, could be found, having been formed far away in exploding stars.

Out of the void

Minerals form from chemical elements in only a few ways. They can crystallise when molten lava becomes a solid; they can be left behind as residues when water carrying dissolved elements evaporates, or they can be deposited in water when concentrations of dissolved elements get too high. In one way or another, atoms of different elements are brought close together to form their crystalline lattices. And once some minerals are formed, more can be created chemically. Usually this happens by exposing minerals to agents that rip away electrons, just as oxygen does during oxidation.

As the planets congealed, gravitational forces and particle collisions created the high temperatures

necessary to melt metals floating around in space, and minerals began their diversification. Once the sun and planets took shape, heat became readily available in the form of solar radiation, asteroid impacts, and gravitational pressure. Magma appeared in abundance and in some locations formed vast molten oceans. Dr Hazen and his team speculate from meteorite and early rock studies that several hundred mineral species, including zircon, quartz, clay and halite salt crystals, formed during this early period of mineral evolution.

Although Mercury and the Moon never progressed beyond the planetary-congealing stage, volcanic activity on Mars, Venus and Earth created powerful forces that caused further mineral diversification. Much of it resulted from volcanoes blasting out gases like carbon dioxide and water vapour, which allowed ice (also a mineral) to form near the poles of Earth, and possibly on Mars too.

Plate tectonics, the formation of faults and the moving of the continental crust over a molten interior, is a characteristic unique to Earth and it meant that minerals evolved far beyond those on any other planet in the Solar System. These epic processes melted and reprocessed vast amounts of rock and concentrated chemical elements in new ways. Massive ore deposits of copper, lead, zinc, silver, gold and other metals formed in this way.

Over 1,500 minerals are thought to have formed on Earth before the beginnings of life some four billion years ago. Obviously, minerals do not have genes and thus cannot mutate as living things do. Nevertheless, when life appeared, the evolution of minerals and the diversity of life became entwined.

Microscopic algae, the earliest living organisms, drew carbon dioxide from the atmosphere and expelled oxygen. Over millions of years this created an oxygen-rich atmosphere that rapidly removed electrons from minerals near the surface, creating rust out of iron and forming thousands of new minerals from other metals like nickel, copper and uranium.

Living stones

In the oceans, as animals with hard parts evolved, their bodies mineralised shells and skeletons for protection and support. Corals too started combining the calcium and carbonate that was floating freely in the water to construct reefs. All of the materials that animals made started to litter the sea floor and this vast accumulation of bone, shell and coral got pressed together into a mineral known as calcite.

On the land, plants produced acids around their roots that converted minerals of volcanic origin, like mica, feldspar and pyroxene, into clay minerals that ultimately formed intensely rich soils. This explains why volcanic islands like Hawaii are so lush.

New minerals created by living things continue to turn up. One of the most recent discoveries was by Hexiong Yang, who named it Hazenite as a tribute to Dr Hazen, his former teacher. Hazenite is a mineral formed by microbes in the highly alkaline Mono Lake in California.

Understanding just how dramatically life shapes minerals will play an important role in the exploration of the universe, says Dr Hazen. Knowing which minerals form at different stages of a planet's evolution, and which depend upon life to be present, are crucial to understanding the mineralogy of other planets and moons.

With NASA's *Messenger* probe now going into orbit around Mercury, Dr Hazen predicts that it will find only 300 or so minerals on the planet. If there are 500-1,000 detected, then it will suggest that there is a lot more to Mercury than anyone originally thought. And if minerals that depend upon life for their formation show up, then researchers will be flummoxed. The same is true for Mars and other planets—including the exoplanets that have been known about but which have just been seen for the first time orbiting stars outside the Solar System (see article). Dr Hazen argues that considering minerals in evolutionary terms is a powerful way to help identify how far a planet has developed geologically. Moreover it can tell you whether life was present at some point—and even whether it is present now.

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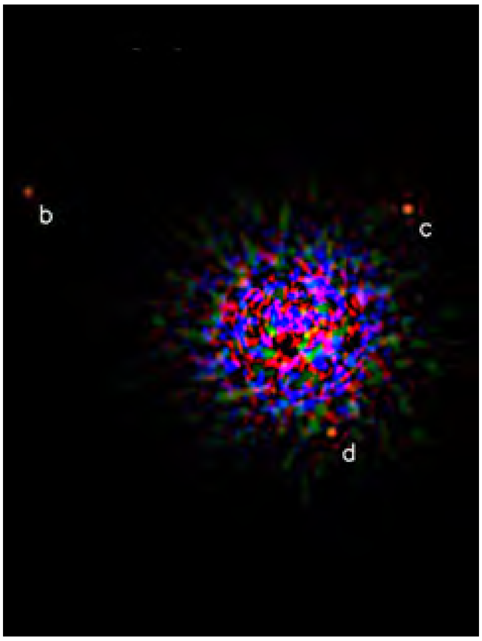
Exoplanets

First sighting

Nov 13th 2008
From The Economist print edition

Planets are seen outside the Solar System

NRC Canada



Tiny red blobs of historic proportions

A FEW grainy smudges and computer-generated blobs are not much to look at. But these are the first images of planets outside the Solar System, or exoplanets as they are called. The star they are orbiting, the mass of blobs seen in the picture, is known only as HR 8799. It is 128 light years from Earth, and is just visible to the naked eye in the constellation of Pegasus. The three red dots, marked b, c and d, are exoplanets.

Since the 1990s more than 300 exoplanets have been found and the number is growing. However, their presence can usually only be inferred through the gravitational influences they have on their nearby star. Images of the three planets at HR 8799, however, were captured directly using two high-altitude telescopes in Hawaii.

This was quite a feat as the intense light from the star normally obscures the subtle visual details necessary to distinguish a planet. However Christian Marois, of the NRC Herzberg Institute of Astrophysics in Canada and his colleagues, developed a computer processing technique that was able to separate the light from HR 8799 from the light the planets are emitting—they are still so young that they are glowing from heat left over from their formation about 60m years ago. Compared with Earth, which is about 4.5 billion years old, these are newly minted.

The three planets are all relatively large, having masses between five and 13 times that of Jupiter, according to a report published in *Science* this week. The smallest exoplanet is closest to the sun and the largest is the farthest away, which is interesting to astronomers because it resembles a scaled up version of the outer part of the Solar System. This lends support to current theories of planetary formation. Planets are believed to emerge from the accretion of particles in a disk of gas and dust as they whirl around the star. The next step is to look at the chemical composition of these planets, their cloud structures and their thermal properties.

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Greenhouse gases

Eating carbon

Nov 13th 2008
From The Economist print edition

There is a type of rock with a voracious appetite for carbon dioxide

ONE way of helping to reduce emissions of carbon dioxide into the atmosphere is to pump the gas into underground caverns or old oil fields. But there is also a rock that is happy to gobble it up, and according to the latest research its appetite for the greenhouse gas is not only massive but could also be increased by a little human intervention.

The rock is peridotite, which is one of the main rocks in the upper mantle, an area that provides a girth below the Earth's crust. The rock occurs some 20km or more down, although in areas where plate tectonics have forced up some of the mantle, peridotite reaches the surface. This happens in part of the Omani desert which Peter Kelemen and Juerg Matter, both from Columbia University, New York, have studied for years.

Geologists have long known that when peridotite is exposed to the air it can react quickly with carbon dioxide to form carbonates like limestone or marble. Some people have looked at the idea of grinding up peridotite and using it to soak up emissions from power stations, but the process turns out to be expensive, partly because of the costs of transporting all the rock. The transportation would also create emissions. In *Proceedings of the National Academy of Sciences*, Messrs Kelemen and Matter suggest an alternative: pumping the gas from places where it is produced and into underground strata of peridotite.

The team has shown that the Omani peridotite absorbs tens of thousands of tonnes of carbon dioxide a year, far more than anyone had thought. By drilling and fracturing the rock they believe they can start a process to increase the absorption rate by 100,000 times or more. They estimate this would allow the Omani outcrop, which extends down some 5km, alone to absorb some 4 billion tonnes of carbon dioxide a year, which is a substantial part of the annual 30 billion or so tonnes of the gas that humans send into the atmosphere, mostly by burning fossil fuels.

With such rocks situated in an area of the world where an increasing amount of energy is produced and consumed, it potentially provides a convenient carbon sink for the region's energy industry, say the researchers. Peridotite can also be found at the surface in other parts of the world, including some Pacific islands, along the coasts of Greece and Croatia, and in smaller deposits in America. Nor is it the only rock with carbon-eating potential. The researchers are now looking at volcanic basalt in a new project in Iceland.

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Genetic disease and evolution

Bad old genes

Nov 13th 2008
From The Economist print edition

For reasons unknown, old genes cause more disease than young ones

DOWN'S syndrome, muscular dystrophy and haemophilia may be among the best-known genetic diseases, but they are most certainly not alone. Several thousand human genes are linked, when they fail to work properly, to more than 4,000 heritable genetic diseases. Moreover, only a handful of these diseases are treatable. Any way of systematising knowledge about them would thus be welcome, starting with features that the genes which cause diseases have in common.

On the face of it, genes that cause diseases do share one thing: they are, in a technical sense, non-essential. Deactivating these genes during embryonic development does not kill the embryo (if it did, then that embryo would be stillborn). This observation has led to the assumption that disease-related genes are recently evolved—for the older a gene is, the more likely it is to be part of the irreducible structure of being alive, and therefore the more likely it is that breaking that gene will be fatal. Another reason for expecting that disease-related genes would be recently evolved is that the older a gene is, the more likely it is that errors and weaknesses that could lead to disease will have been eliminated by natural selection.

The face of things, however, is not always the underlying truth, and by digging a little deeper Tomislav Domazet-Loso and Diethard Tautz of the Max-Planck Institute for Evolutionary Biology in Plön, Germany, have come up with a surprising discovery. Disease genes tend to be about the same age. But these genes are old, rather than young.

Dr Domazet-Loso and Dr Tautz used an approach called phylostratigraphy. Comparing the genomes of species from different parts of the tree of life allows researchers to work out when a particular gene appeared. Something shared by multicellular animals but not found in protozoa, for example, probably arose about 700m years ago, when multicellularity appeared. Something found in amphibians, reptiles, birds and mammals, but not fish, would be about 370m years old—the point in history when limbs evolved. Using this information, the two researchers were able to trace the ages of genes implicated in genetic disease.

As they reveal in a paper in *Molecular Biology and Evolution*, the researchers found that the majority of disease-causing genes were present in single-celled organisms and that most of the rest arose when multicellular creatures began to evolve. Genes specific to mammals, by contrast, barely ever carry diseases.

Dr Domazet-Loso and Dr Tautz do not have an explanation for why genetic diseases seem to be caused so disproportionately by old genes, but their discovery does suggest that such diseases are an inescapable component of life which even evolution cannot get rid of. That does not point to a systematic way of treating them, but it could help to narrow the search for genes involved in those hereditary diseases that are, at the moment, mysterious.

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Economist.com SCIENCE & TECHNOLOGY

Neurology

Light revival

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Researchers are discovering how light can manipulate the nervous system

A FEW years ago researchers found a way to create a remotely controlled on-off switch in a neuron by inserting a light-sensitive gene into the nerve cell. Now the same technique has been used experimentally in laboratory rats in a study that could help with spinal-cord injuries.

When the spinal cord is severed instructions being sent from the brain are interrupted. This means not just the loss of the ability to move limbs, but also impairment of the up and down movement of the diaphragm too. This leaves patients unable to breathe on their own and often causes death.

Jerry Silver, a neuroscientist at Case Western Reserve University in Cleveland, Ohio, wanted to know if he could use light-sensitive genes to stimulate activity in neurons that control the diaphragm. Dr Silver and his colleagues partly severed the spinal cords of laboratory rats at the second vertebra. This is where the neck swivels, and where many humans suffer spinal-cord injuries. It is also where neurons that control breathing are located.

The partial injury (there are no ventilators for rats, so the researchers could not completely sever the cord without killing them) allowed only one side of the diaphragm to work and the rats had trouble breathing. A virus carrying genes for a light-sensitive protein called Channelrhodopsin-2 was then injected into neurons located just below the injury, at an area also involved with the diaphragm.

Four days later, the animals' spines were opened. The application of continuous light on them had no effect. But as cells seem to respond most to patterns, the researchers experimented with various pulses of light. Several hours after a session which involved one-second pulses for five minutes followed by five minutes of rest, the rats began breathing normally for a day and a half.

Tests confirmed that their blood was well oxygenated and, perhaps more remarkably, that the two halves of their diaphragms were working in step with each other. This, Dr Silver is convinced, is because the activity in the light-sensitive neurons somehow activated a latent nerve pathway that spans both sides of the spinal cord, allowing them to synchronise.

Dr Silver is hopeful that the work on rats, which is published in the *Journal of Neuroscience*, will have relevance to humans—and not just those with spinal-cord injuries. The technique could eventually help people suffering from amyotrophic lateral sclerosis and multiple sclerosis. It might also lead to useful "off" switches as well as "on" ones, which could allow certain conditions, such as chronic pain, to be turned off.

How to get light to the neurons once they have been treated without cutting people up is a problem that Dr Silver expects soon to be resolved. Methods are already being developed to implant a light source inside the body which could be activated by remote control. Another method would be to pipe the light in through tiny cables. The fibre-optic age may be about to strike neurosurgery.

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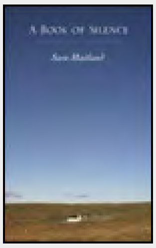
Out of this world

Nov 13th 2008
From The Economist print edition

The transcendental effects of silence

A Book of Silence
By Sara Maitland



Granta; 309 pages; £17.99

Buy it at
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Illustration by Daniel Pudles

SARA MAITLAND'S book is not about peace and quiet. It is about silence as a practice, a discipline, a way of life. A cottage in the country will not do. It is more a matter of desert caves and open oceans, or, in her case, wild Scottish moorland. It's the real deal.

How Ms Maitland gets to that point is a long story; a hunt for greater solitude and further remoteness along the length of Britain, with a detour to the Sinai desert, which she describes with a disarming sense of being thought mad. Her friends tell her she is, and she realises that the modern world has little room for serious silence seekers. It is not just that blasting radios, mobile phones, traffic and aeroplanes can be a source of despair. It is also the assumption that communication and relationships are central to all human life. Ms Maitland knows this because she has been there. Brought up in a large, articulate family, she was nourished on argument. Her politics, her feminism and her religion all fed on talk. In such a context, silence becomes an absence, a mark of intellectual abdication, a rejection of humanity.

Ms Maitland is a Roman Catholic convert and she is frank about her desire "to explore my own spirituality

and deepen my growing sense of the reality of God". But "A Book of Silence" is not primarily a work of theology. What interests the author is silence itself, wherever it leads. In the face of hostility and suspicion she wants to rehabilitate it, to discover its history, to call on witnesses from every tradition and every kind of circumstance—from early Christian hermits to the Romantic poets to single-handed sailors and mountaineers. It is both an analytical, theoretical fascination and a personal one, her reading and her experience locked together, each testing and illuminating the other.

So what is silence like? Ms Maitland does not pull her punches. At various times she has heard choirs singing in Latin from the bedroom. She has been spooked and sapped of energy. She has lost track of time, felt her identity dissolving, lost her inhibitions, forgotten to wash. She is not alone in this. Some of it appears in the literature on sensory deprivation. But it also appears in the literature of transcendence.

Transcendent silence comes in many colours—and little of it is exactly silent. Lindisfarne, the Holy Island, shrieks with birds; the moors and mountains howl with wind and rain. Only the desert achieves it, but at a price. It was there, reading the sayings of the desert fathers and Athanasius's "Life of St Anthony", that Ms Maitland found herself most strangely moved. The hermits' fierce self-abnegation, their holy self-emptying seemed to her thrilling. She wanted to be like them; she was transported. And yet. Readers will know Ms Maitland as a novelist and short-story writer. The silence of the desert has its uses for the mystic, but what she experienced as a writer was that it destroys not only the sense of self, but also the foundation of narrative art—a sense of time and memory.

In the end, it was on the moors of Galloway, her birthplace, and in the spirit of the Romantic poets that Ms Maitland was able to unite transcendence with a heightened rather than a diminished sense of individuality. She walked the hills like Dorothy Wordsworth and, like William Wordsworth, paddled a boat among the reflections of the stars, the dragonflies "coming up from the depths to meet the real dragonflies as they skim down onto the surface, which is the skin between the two worlds of air and water".

There are several such passages of vivid recollection: the sudden feeling once, on some mountainside, of being physically connected to everything; waking on a night of swarming stars; watching the desert dawn; being transfixed by Mark Rothko's paintings: "dense pools of silent energy". One could wish for more. If there is one criticism of this book, it is that there is an occasional sense of strain, of intellectual contrivance. Ms Maitland's own experience is sometimes drowned in commentary, as though she were unsure of her audience. She can afford to relax. Many of her readers, religious or not, will be more than halfway with her.

A Book of Silence.
By Sara Maitland.
Granta; 309 pages; £17.99

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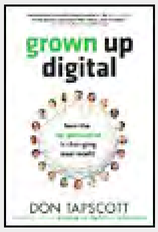
The net generation

The kids are alright

Nov 13th 2008
From The Economist print edition

WORRIES about the damage the internet may be doing to young people has produced a mountain of books—a suitably old technology in which to express concerns about the new. Robert Bly claims that, thanks to the internet, the "neo-cortex is finally eating itself". Today's youth may be web-savvy, but they also stand accused of being unread, bad at communicating, socially inept, shameless, dishonest, work-shy, narcissistic and indifferent to the needs of others.

Grown Up Digital: How the Net Generation is Changing Your World
By Don Tapscott



McGraw-Hill; 384 pages; $27.95 and £15.99

Buy it at
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The man who christened the "net generation" in his 1997 bestseller, "Growing Up Digital", has no time for such views. In the past two years, Don Tapscott has overseen a $4.5m study of nearly 8,000 people in 12 countries born between 1978 and 1994. In "Grown Up Digital" he uses the results to paint a portrait of this generation that is entertaining, optimistic and convincing. The problem, he suspects, is not the net generation but befuddled baby-boomers, who once sang along with Bob Dylan that "something is happening here, but you don't know what it is", yet now find that they are clueless about the revolutionary changes taking place among the young.

Jupiter Images

Web wizards

"As the first global generation ever, the Net Geners are smarter, quicker and more tolerant of diversity than their predecessors," Mr Tapscott argues. "These empowered young people are beginning to transform every institution of modern life." They care strongly about justice, and are actively trying to improve society—witness their role in the recent Obama campaign, in which they organised themselves through the internet and mobile phones and campaigned on YouTube. Mr Tapscott's prescient chapter on "The Net Generation and Democracy: Obama, Social Networks and Citizen Engagement" alone should ensure his book a wide readership.

Contrary to the claims that video games, Facebook and constant text-messaging have robbed today's young of the ability to think, Mr Tapscott believes that "Net Geners" are the "smartest generation ever". The experience of parents who grew up watching television is misleading when it comes to judging the 20,000 hours on the internet and 10,000 hours playing video games already spent by a typical 20-year-old American today. "The Net Generation is in many ways the antithesis of the TV generation," he argues. One-way broadcasting via television created passive couch potatoes, whereas the net is interactive, and, he says, stimulates and improves the brain.

There is growing neuroscientific support for this claim. People who play video games, for example, have been found to process complex visual information more quickly. They may also be better at multi-tasking than earlier generations, which equips them better for the modern world.

Mr Tapscott identifies eight norms that define Net Geners, which he believes everyone should take on board to avoid being swept away by the sort of generational tsunami that helped Barack Obama beat John McCain. Net Geners value freedom and choice in everything they do. They love to customise and personalise. They scrutinise everything. They demand integrity and openness, including when deciding what to buy and where to work. They want entertainment and play in their work and education, as well as their social life. They love to collaborate. They expect everything to happen fast. And they expect constant innovation.

These patterns have important implications for the workplace. Employers who ban the use of Facebook in the office—the equivalent of forbidding older staff to use their rolodexes—show clear signs of being out of touch, he argues. Two out of three Net Geners feel that “working and having fun can and should be the same thing”. That does not mean they want to play games all day, but that they want the work itself to be enjoyable. They also expect collaboration, constant feedback and rapid career advancement based on merit. How they will react to being fired en masse as the downturn worsens remains to be seen, but Mr Tapscott suspects they will take it in their stride.

Two things do worry Mr Tapscott. One is the inadequacy of the education system in many countries; while two-thirds of Net Geners will be the smartest generation ever, the other third is failing to achieve its potential. Here the fault is the education, not the internet, which needs to be given a much bigger role in classrooms (real and virtual). The second is the net generation’s lack of any regard for personal privacy, which Mr Tapscott says is a “serious mistake, and most of them don’t realise it.” Already, posting pictures of alcohol fuelled parties, let alone mentioning drug use or other intimate matters, is causing a growing number of job applicants to fail the “reference test” as employers trawl Facebook and MySpace for clues about the character and behaviour of potential employees.

More optimistically, the Net Geners are much more positive than their predecessors about their family. Half of those interviewed regard at least one parent as their “hero”. Mr Tapscott believes the internet is producing an improved, more collaborative version of family life, which he calls the “open family”. Parents increasingly recognise that their youngsters have digital expertise they lack but want to tap, and also that their best defence against their children falling foul of the dark side of the internet, such as online sexual predators, is to win their children’s trust through honest conversation. Ironically, Mr Tapscott’s recommended “platform” for this essential social networking could hardly be more old tech: the family dinner table.

Grown Up Digital: How the Net Generation is Changing Your World.
By Don Tapscott.
McGraw-Hill; 384 pages; $27.95 and £15.99

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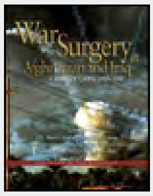
War surgery in Iraq

Standard operating procedures

Nov 13th 2008
From The Economist print edition

War Surgery in Iraq and Afghanistan: A Series of Cases, 2003-2007
Edited by Shawn Christian Nessen, Dave Edmond Lounsbury and Stephen P. Hetz



US Army Office of the Surgeon General/Borden Institute; 442 pages; $71

Buy it at
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FEW modern surgical texts have been as contentious as “War Surgery in Iraq and Afghanistan”. Rumours of its graphic content were circulating in surgical circles well before the book came out. The American military censors reportedly tried to have the book refused an ISBN code, which would have prevented it being sold commercially. A retired US Army surgeon general said the military command was concerned that the book’s graphic images “could be spun politically to show the horrors of war”.

Horrors there are: the shredding lacerations of blast; cavitating high-velocity ballistic wounds; injuries from “biological projectiles” formed of body fragments from other victims dismembered in explosions. Civilian casualties include children riddled with shrapnel and a pregnant woman shot through her belly. Each case is laid out in detail; the raw verity of digital photographs from the operating table beside surgical notes written up in the immediate aftermath of resuscitation. The book’s publication earlier in the summer coincided with complaints by American news photographers that they were being refused access to combat operations lest they depict American casualties.

There has never been a surgical reference like it, for several reasons. Throughout the text are graphic colour photographs: phosphorus bursts white against black sky, a Humvee aflame on a bleak highway. The section on “high energy orthopaedic polytrauma” (high-velocity multiple bone injuries) places a scan of a shattered pelvis beside a close-up of a belt of machine-gun bullets, highlighting the irony of striving to save life in the moral vacuum of war.

The book’s introduction categorises different types of casualties and the care that is available to them. For example, American soldiers and “embedded” American journalists (such as Bob Woodruff of ABC News, who has written in the foreword about his own experience of being wounded) receive optimal treatment at each step through the military medical and rehabilitation system. Enemy combatants, who are denied the protection of the Geneva Convention, are treated in American military hospitals until they are fit enough to be transferred to Bagram air base or Guantánamo Bay. “Host-nation nationals”, Iraqi and Afghan soldiers and civilians, receive emergency care before being passed back to whatever facilities exist in their own health services. “The dichotomy of different pathways of care for American versus host-nation casualties”, observes the introduction, “remains an ongoing challenge.”

The diversity of cases makes the book unique as a reference of war surgery practice. The collection of wound data by the Borden Institute, the co-publisher, and the rigorous analysis of response to injury, allow prompt assessment of treatment and resuscitation techniques. In the course of the fighting in Iraq and Afghanistan the number of deaths that result from haemorrhage has been hugely reduced by improved tourniquets, new compounds to stop bleeding and fundamental changes in the types of fluids transfused to treat shock. New surgical approaches to complex injuries are being rapidly evaluated and applied. The book is dense—about the size and mass of the chest-plate in a set of body armour—and will save many lives. “War Surgery in Afghanistan and Iraq” should be part of every front-line surgeon’s armoury.

War Surgery in Iraq and Afghanistan: A Series of Cases, 2003-2007.
Edited by Shawn Christian Nessen, Dave Edmond Lounsbury and Stephen P. Hetz.
US Army Office of the Surgeon General/Borden Institute; 442 pages;

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The making of “Gray's Anatomy”

Fearfully and wonderfully made

Nov 13th 2008
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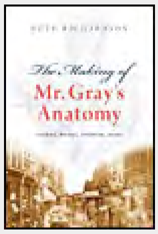
IT WAS murder that finally did for the resurrectionists. By the 19th century a growing and increasingly scientific medical profession needed plenty of corpses on which to learn. But the fear that being cut up after death would mean missing the Last Trump while trying to reassemble one’s body meant few of the dying or bereaved were willing to assist. So the legitimate supply consisted largely of the corpses of executed criminals, dissected as their final punishment. Resurrectionists prowled graveyards; anatomy schools bought their plunders; and the authorities, convinced of the trade’s necessity, looked away.

The Making of Mr Gray's Anatomy: Bodies, Books, Fortune, Fame
By Ruth Richardson



Oxford University Press; 322 pages; $29.95 and £16.99

Buy it at
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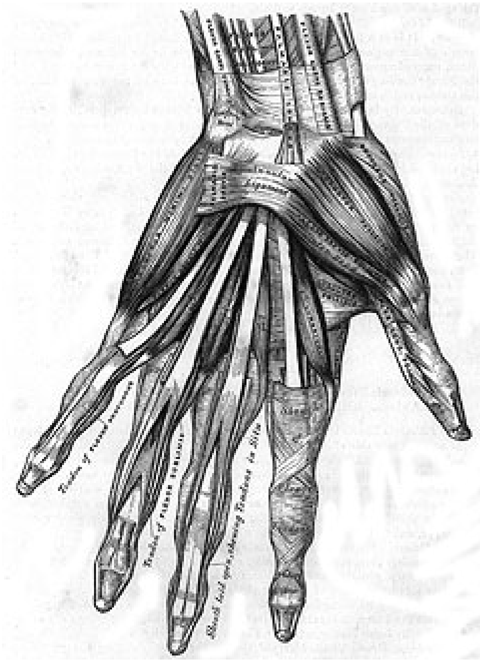
Then in 1827 William Burke and William Hare started selling corpses that were extra-fresh. Burke was hanged for murder in 1829 (Hare turned king’s witness) and the scandal led to the 1832 Anatomy Act, which allowed hospitals and workhouses to hand over for dissection bodies left unclaimed for two days.

Oxford University Press



Handy work

Thus, when in 1855 an ambitious young surgeon at London’s St George’s Hospital decided to write an affordable, elegantly illustrated anatomy textbook, subjects for the illustrations were plentiful. And there was a gap in the market between collector’s items such as William Hunter’s “The Human Gravid Uterus”, with its realistic copperplate images, and various cheaper textbooks illustrated with cramped woodcuts. Thus was born the doctor’s bible: “Gray’s Anatomy”, in print continuously since 1858 and now in its 40th edition.

Ruth Richardson’s history is suitably elegant and detailed. “Gray’s Anatomy”was beautifully produced and illustrated. One reason for its success was its clarity, another was the amount it packed in. Her real hero is not the brilliant, successful, well-connected Henry Gray, who wrote the words, and whose name appeared on the spine, but Henry Vandyke Carter, a diffident, poor, non-Conformist colleague he employed to draw the illustrations. That is partly because much more is known about Carter; his diaries survive, whereas none of Gray’s papers does. (Gray died of smallpox aged 34 and his belongings were probably burnt as an anti-infection measure.)

A more important reason is the power and brilliance of Carter’s drawings. Their originality is difficult to comprehend now, because they have shaped the very way we visualise humans beneath their skin. Ms Richardson compares them with those by earlier illustrators to reawaken the reader’s admiration. Her juxtaposition of the uterus as drawn by Jones Quain, its lines clumsy, the organs draped in a curtain of flesh, the whole shown nailed to a board as it would have been for anatomy demonstrations, and Carter’s version, highlights the beauty and respectfulness of the latter, its lines delicate yet confident, the whole lacking in prurience and some distance from the woman whose death made it possible. “Gray’s Anatomy” was the first major anatomy textbook written since the advent of chloroform. “These are painless dissections,” writes Ms Richardson, mercifully lacking the “static sadism” of their predecessors.

Although the Anatomy Act ended body snatching, the stigma of dissection remained. Ms Richardson’s analysis of the records of St George’s suggests that, like most other teaching hospitals, it connived with

(and probably paid) workhouse managers who saw that the bereaved missed their chance to claim bodies, and who went to little trouble to ascertain the wishes of those who died friendless. We know nothing of the several men, one or two women and at least one child drawn by Carter, and can only guess at what brought them to the dissecting table. One of the loveliest things about this book is that it returns them to their rightful place at the heart of the story of “Gray’s Anatomy”, peeled to the bone and transformed into Everyman, forgotten, yet immortal.

The Making of Mr Gray’s Anatomy: Bodies, Books, Fortune, Fame.
By Ruth Richardson.
Oxford University Press; 322 pages; $29.95 and £16.99

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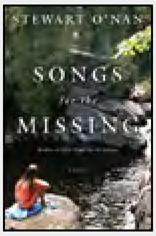
New fiction

Stewart O'Nan

Nov 13th 2008
From The Economist print edition

SUMMER in small-town America. Three 18-year-olds count the days until they can leave Kingsville, Ohio, for college. They long to be independent, to get away from the place where everyone knows their business, to escape “the sins of the Midwest, the flatness, the emptiness, the necessary acceptance of the familiar”. The leader of the three is Kim Larsen, pretty, popular, restless, whiling away her days working at the local Conoco, drinking beer with her friends, dreaming of what the future holds. Then, in the midst of this ordinary life in an ordinary place, the extraordinary happens. Kim disappears.

Songs for the Missing



Viking; 287 pages; $25.95

Buy it at
Amazon.com
Amazon.co.uk

Within days, the Larsen home has become the centre of a frantic campaign to find the missing girl. Her quiet mother Fran, a hospital worker, “trusting efficiency over emotion”, prints flyers and posters, badges and T-shirts, organises press conferences, TV interviews, rallies. Somewhat repelled by his wife’s marketing of their distress, Ed, Kim’s estate-agent father, becomes ever more practical, liaising with the police, commandeering teams of searchers, spending days picking over acres of land in search of clues to his daughter’s disappearance. Lindsay, the awkward younger sister, always in Kim’s shadow, retreats to her room. She misses her sibling but is also resentful of the attention surrounding her.

As in his previous novels, Stewart O’Nan draws the reader deep into the minutiae of the lives of his characters; the glasses of wine Fran pours to anaesthetise her emotional turmoil; a family meal of barbequed chicken, potato salad and an empty chair at the table; Lindsay snooping through Kim’s untouched room—“She could feel Kim here, and smell her”—with its half-dozen bottles of perfume that her sister refused to share but that Lindsay had secretly tested.

The author’s decision to focus on the day-to-day existence of a family under unbearable strain makes this book far more compelling than a standard police procedural. Choosing to avoid the what, who and why of Kim’s disappearance, Mr O’Nan instead paints a nuanced portrait of how people are changed by tragic events and the far-reaching effect a person’s disappearance has on their family and community. “Songs for the Missing” is an elegantly crafted, memorable book that resonates with sadness.

Songs for the Missing.
Viking; 287 pages; $25.95

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Economist.com BOOKS & ARTS

Georgian treasure

Ancient bling

Nov 13th 2008
From The Economist print edition

A travelling show of Georgian treasures

IT WAS gold, not tanks, that made front-page news in Tbilisi in May 1876. Residents of the hilly area of Vani, in what is now the Republic of Georgia, stepped out after a downpour and found a collection of beautifully crafted, ancient gold jewels lying in the muddy streets. The discovery of these intricately worked bracelets and earrings, head ornaments and necklaces, which had been washed down from tombs and sanctuaries, quickly attracted the interest of archaeologists. On and off, they have been excavating there ever since.

Georgian National Museum

Turtle love

Now some 140 of the artefacts, many of them recent discoveries, are the focus of a new exhibition at the Fitzwilliam Museum in Cambridge, England, until January 4th. ("From the Land of the Golden Fleece: Tomb Treasures of Ancient Georgia" will then travel to the Benaki Museum in Athens, Greece, and the J. Paul Getty Museum in Los Angeles.)

These pieces of gold and silver jewellery, all of exceptional charm and sophistication, are a revelation. Few outside Georgia have seen them, indeed not many outside the archaeological profession have been aware of their existence. The exhibition catalogue is the first time this hoard has been written up in detail in English.

These objects were fashioned between the fifth and first centuries BC. The region was known then as Colchis. The Greeks referred to it as "polychrysos", meaning "rich in gold". On the eastern shore of the Black Sea, the region lay on a trade route that stretched to India. It is believed to be the land to which Jason and the Argonauts set sail in pursuit of the magical Golden Fleece. Not only was gold mined there, it was found in rivers too, where the gold particles were collected using lanolin-rich sheepskins.

The region was influenced by many different cultures. One of the sculptures in this exhibition is an elegant second-century-BC bronze torso of a youth—its surface sensitively patched to smooth out casting flaws—clearly bearing Greek influence. Last year a number of other superb Hellenistic pieces were also found at Vani, though whether these were made there or imported is still unclear.

Whereas these pieces are exceptional, even more extraordinary, says Timothy Potts, the Fitzwilliam's director, are those that reflect the technical accomplishment and imaginative character of the local people. The exhibition has abundant examples, ranging from the visually powerful, if conceptually primitive, iron statuettes used in religious rituals, to many elaborate golden jewels with ornamentation showing animals and birds.

Among the most delightful is a necklace of gold beads from which hang gold turtles (pictured above). The back of each turtle seems to dance with reflected light. The Colchis artisans used granulation—applying tiny gold balls to the work's surface—to achieve the sparkling effect. Lost for centuries, the technique

was only rediscovered in the early 20th century.

Colchis was famed for the quality and abundance of its wine, which is believed to have been produced there as early as 8000BC. The site at Vani has yielded many implements associated with wine-drinking and production, as well as with Dionysus, the Greek god of wine. The most engaging of these are the second-century-BC bronze appliqués—faces in deep relief intended to be attached to a vase. The most arresting is the wild visage of Pan, eyes wide, mouth open, baring his teeth. The image of a satyr, by contrast although of the same size and material, has a goofy sweetness about it, like a creature pleasantly tipsy. These treasures, which will return to Vani after this tour, have had little publicity. Be sure to catch them where you can.

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Economist.com
PEOPLE
OBITUARY

Miriam Makeba

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From The Economist print edition

Miriam “Zenzi” Makeba, a voice against apartheid, died on November 10th, aged 76

africanpictures.net

SHE told reporters she was shy. When Nelson Mandela came in the 1950s to meet the band she sang with, she sat quietly in the corner and let the men do the talking. Years later, when she was introduced to John Kennedy at the White House, she was awed at the thought that “little me”, a “songbird”, had held the smooth white hand of the president. Her speaking voice was thin, light and high, an ant’s voice, as she thought of it. It never sounded thinner or shyer than when she sat alone in 1963 in a vast auditorium of the United Nations, a young woman in a sensible dress, explaining the evils of apartheid to an assembly of empty leather chairs.

All her conditioning taught her to be quiet. She was hushed from her first days, as her mother suckled her in the jail to which she had been sent for illegally brewing and selling beer. She kept her silence as a teenager, nannying and doing household chores for whites who would look at her as if they owned her. (On her first trip to Europe, in 1959, she was amazed to see white women carrying burdens and white men digging ditches, with sweaty handkerchiefs round their heads.) After shows in the drinking houses of Sophiatown, an island of dirt roads and raucous black culture in the white suburbs of Johannesburg, she knew she had to leave through the scullery to avoid mixing with whites.

But something happened to Miriam Makeba whenever she started to sing. After a slow saunter onstage, gazing at her high-heeled shoes, she would suddenly straighten her back, flex her muscles, throw back her head and let loose an incandescent smile. Her strong, lithe body writhed and shook. Her shoulders shrugged, her hips gyrated. Slinky, strutting, wild-eyed and joyous, she danced as she sang:

Yiyo mama yiyo mama
(Nantsi, pata pata)
Yiyo mama yiyo mama
(Nantsi, pata pata)

“Pata Pata” (“Touch touch”) was a pulsing township dance, a celebration of Friday night freedom. At 76, stiff with osteoarthritis, she still attempted it, slowly revolving her broad, swaying beam. “Music gets deep inside me,” she explained once, “and starts to shake things up.”

Ms Makeba could soar like an opera singer, but she could also whisper, roar, hiss, growl and shout. She could sing while making the epiglottal clicks of the Xhosa language. Clicking, clapping, dancing or dreaming, laughing or sad, she seemed to contain all the strength, warmth, sensuousness and burnished beauty of Africa, as well as all its sounds. After wondering why anyone would make her “carry a whole continent”, she happily accepted that she was “Mama Africa” itself.

It was not jazz she was singing. She said she didn’t know what that was. Billie Holiday and Ella Fitzgerald were her early heroines, but they just made “music” to her, and she was moved whenever anyone sang, from her mother’s prayers onwards. Nor was she political, by her lights. Again, she didn’t understand the word. Mere humanity was the theme of her songs: children, ageing, fleabites, secret kissing, the sting of love without money. It was natural, she said, for black South Africans to sing their lives and to turn their “cries from the heart” into rhythm and joy. She simply did the same.

Loving Stokely

There was plenty of pain. Five marriages, four ending in divorce, the first with a man who beat her and the fourth, in 1968, with Stokely Carmichael, the leader of America’s Black Panthers. She loved him, and failed to see what loving Stokely had to do with anything else. But the American record companies that had propelled her from local African band tours to Western stardom cancelled her contracts and her concerts, and she moved with him to Guinea, where the president gave them shelter. There, too, she buried her only child, a troubled daughter who had died giving birth to a stillborn son.

Sharper even than this sadness was the fact that, for more than 30 years, she was an exile from her homeland. An appearance in 1959 in an anti-apartheid film, singing two songs, caused the South African authorities to revoke her passport while she was away. Again, she felt she had done nothing wrong as the official stamped “Invalid” on the pages. Three years later, after she had addressed the UN, her citizenship was revoked. She did not return until 1990, when Mr Mandela left prison. She came home, full of tears, to find herself a star.

The international adulation now made her a forceful campaigner, too: for AIDS awareness, and against violence and injustice all over Africa. She was campaigning as she died, in Italy, for the right to speak out against the Mafia. But music, pure, simple, apparently unpolitical, remained her weapon of first resort. What it had done for her, in the choir at Kilnerton Training Institute or fronting the Manhattan Brothers in the smoky shebeens of Sophiatown, it could also do for each member of the oppressed and dispossessed. Distance, like exile, made no difference. Every time she stepped on a stage, resplendent in gold brocade or high hats or a sheath of shiny leopard skin, she unleashed the power of music to thrill, shock, elevate, and set men and women free.

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Overview

Nov 13th 2008
From The Economist print edition

The unemployment rate in **America** rose from 6.1% to 6.5% in October, its highest level since 1994. Employers, excluding farms, reduced their payrolls by 240,000 in that month. The number of jobs cut in September was revised up by 125,000 to 284,000, and in August by 54,000 to 127,000.

Britain's unemployment rate rose to 5.8% in the three months to September from 5.4% in the previous quarter. The number of people claiming unemployment benefits rose by 36,500 in October, the biggest increase since 1992. Average earnings rose by 3.3% in the year to the third quarter.

German GDP fell by 0.5% in the third quarter. This was the second successive quarter in which Europe's biggest economy had shrunk.

Consumer-price inflation in **China** fell from 4.6% in September to 4% in October. The value of retail sales rose by 22% in the year to October, a slightly slower pace than in September. China's trade surplus widened to $35.2 billion in October, a new record, mostly because of a sharp slowdown in imports.

In **Japan**, orders for new machinery fell by 10.4% in the third quarter compared with the previous three months. The decline matched the record drop recorded in 1998.

Consumer prices in **Sweden** rose by 4% in the year to October, easing from 4.4% in the year to September. Inflation in **Norway** edged up from 5.3% to 5.5% in October. **Mexico's** inflation rate picked up from 5.5% to 5.8%.

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Output, prices and jobs

Nov 13th 2008
From The Economist print edition

Output, prices and jobs

% change on year ago

	Gross domestic product				Industrial production	Consumer prices			Unemployment
	latest	qtr*	2008†	2009†	latest	latest	year ago	2008†	rate‡, %
United States	+0.8 Q3	−0.3	+1.6	+0.6	−4.5 Sep	+4.9 Sep	+2.8	+4.5	6.5 Oct
Japan	+0.7 Q2	−3.0	+0.7	+0.6	+0.2 Sep	+2.1 Sep	−0.2	+1.8	4.0 Sep
China	+9.0 Q3	na	+9.8	+8.5	+8.2 Oct	+4.0 Oct	+6.5	+6.4	9.5 2007
Britain	+0.3 Q3	−2.0	+1.1	+0.1	−2.2 Sep	+5.2 Sep§	+1.8	+3.8	5.8 Sep††
Canada	+0.7 Q2	+0.3	+0.8	+1.4	−3.3 Aug	+3.4 Sep	+2.5	+2.8	6.1 Sep
Euro area	+1.4 Q2	−0.7	+1.2	+0.6	−2.4 Sep	+3.2 Oct	+2.6	+3.5	7.5 Sep
Austria	+2.2 Q2	+1.5	+2.1	+1.0	+4.6 Aug	+3.7 Sep	+2.1	+3.0	3.2 Sep
Belgium	+1.2 Q3	+0.4	+1.5	+0.9	−5.0 Aug	+4.7 Oct	+2.2	+4.5	10.9 Sep‡‡
France	+1.1 Q2	−1.3	+1.1	+0.7	−1.9 Sep	+2.7 Oct	+2.0	+3.2	7.9 Sep
Germany	+0.8 Q3	−2.1	+1.6	+0.6	−2.3 Sep	+2.4 Oct	+2.8	+2.9	7.5 Oct
Greece	+3.5 Q2	+3.1	+2.4	+1.5	−3.3 Sep	+3.9 Oct	+3.1	+4.6	7.0 Jul
Italy	−0.1 Q2	−1.1	+0.1	+0.3	−5.7 Sep	+3.5 Oct	+2.1	+3.6	6.8 Q2
Netherlands	+3.0 Q2	+0.5	+2.1	+1.0	−1.6 Sep	+2.8 Oct	+1.6	+2.5	3.8 Sep††
Spain	+1.8 Q2	+0.4	+1.4	+0.3	−4.5 Sep	+3.6 Oct	+3.6	+4.5	11.9 Sep
Czech Republic	+4.6 Q2	+3.6	+4.5	+4.3	+3.4 Sep	+6.0 Oct	+4.0	+6.6	5.2 Oct
Denmark	+0.9 Q2	+1.6	+0.6	+0.8	+0.1 Sep	+3.7 Oct	+1.7	+3.3	1.6 Sep
Hungary	+2.0 Q2	+2.3	+2.0	+3.0	−0.7 Sep	+5.1 Oct	+6.7	+6.7	7.7 Sep††
Norway	+5.9 Q2	+2.4	+2.5	+2.2	−4.2 Sep	+5.5 Oct	−0.2	+3.3	2.4 Jul***
Poland	+5.8 Q2	na	+5.3	+3.8	+7.0 Sep	+4.5 Sep	+2.3	+4.3	8.9 Sep‡‡
Russia	+7.8 Q2	na	+7.5	+6.8	+6.3 Sep	+16.1 Sep	+9.4	+14.0	5.3 Sep‡‡
Sweden	+0.7 Q2	−0.1	+1.3	+1.0	−4.9 Sep	+4.0 Oct	+2.7	+3.8	5.7 Oct‡‡
Switzerland	+2.4 Q2	+1.5	+2.0	+1.1	+6.1 Q2	+2.6 Oct	+1.3	+2.6	2.6 Sep
Turkey	+1.9 Q2	na	+3.7	+3.2	−5.5 Sep	+12.0 Oct	+7.0	+10.2	9.0 Q3‡‡
Australia	+2.7 Q2	+1.1	+2.6	+2.3	+2.8 Q2	+5.0 Q3	+1.9	+4.2	4.3 Oct
Hong Kong	+4.2 Q2	−5.5	+3.8	+2.1	−4.2 Q2	+3.0 Sep	+1.6	+5.3	3.4 Sep††
India	+7.9 Q2	na	+7.3	+6.8	+4.8 Sep	+9.8 Sep	+6.4	+7.9	7.2 2007
Indonesia	+6.5 Q2	na	+5.8	+5.5	+2.9 Aug	+11.8 Oct	+5.8	+10.3	8.5 Feb
Malaysia	+6.3 Q2	na	+5.6	+4.6	−1.7 Sep	+8.2 Sep	+1.8	+5.8	3.5 Q2
Pakistan	+5.8 2008**	na	+6.0	+2.9	−5.6 Aug	+25.0 Oct	+9.3	+20.8	5.6 2007
Singapore	−0.5 Q3	−6.3	+4.0	+3.8	+2.4 Sep	+6.7 Sep	+2.7	+6.5	2.2 Q3
South Korea	+3.9 Q3	+2.3	+4.6	+3.3	+6.1 Sep	+4.8 Oct	+3.0	+4.9	3.1 Oct
Taiwan	+4.3 Q2	na	+4.0	+3.4	−1.4 Sep	+2.4 Oct	+5.3	+3.8	4.1 Sep
Thailand	+5.3 Q2	+2.9	+4.8	+3.9	+4.6 Sep	+3.9 Oct	+2.5	+6.4	1.3 Jul
Argentina	+7.5 Q2	+8.7	+6.2	+2.2	+4.4 Sep	+8.4 Oct	+8.4	+9.0	7.8 Q3‡‡
Brazil	+6.1 Q2	+6.6	+5.3	+2.7	+9.8 Sep	+6.4 Oct	+4.1	+5.8	7.6 Sep‡‡
Chile	+4.3 Q2	+7.4	+3.9	+3.3	+3.2 Sep	+9.9 Oct	+6.5	+8.7	7.8 Sep††‡‡
Colombia	+3.7 Q2	+2.8	+4.5	+4.0	−8.8 Aug	+7.9 Oct	+5.2	+6.7	11.1 Sep‡‡
Mexico	+2.8 Q2	+0.6	+1.9	+0.9	−1.6 Aug	+5.8 Oct	+3.7	+5.3	4.3 Sep‡‡
Venezuela	+7.1 Q2	na	+5.4	+2.7	+3.6 Jul	+35.6 Oct	+17.2	+31.0	7.5 Q2‡‡
Egypt	+6.8 Q2	na	+7.1	+6.7	+6.8 Q2	+20.2 Oct	+7.5	+17.1	8.4 Q2‡‡
Israel	+4.9 Q2	+4.2	+4.2	+2.8	+13.9 Aug	+5.5 Sep	+1.4	+4.8	5.9 Q2
Saudi Arabia	+3.5 2007	na	+6.5	+3.3	na	+10.4 Sep	+4.9	+8.5	na
South Africa	+4.5 Q2	+4.9	+3.5	+2.5	+4.9 Sep	+13.1 Sep	+7.2	+11.3	23.2 Sep‡‡
MORE COUNTRIES Data for the countries below are not provided in printed editions of *The Economist*									
Estonia	−3.3 Q3	na	−1.5	+0.4	−3.8 Sep	+9.8 Oct	+8.5	+10.5	4.0 Jul
Finland	+2.4 Q2	+3.1	+2.6	+1.1	+0.8 Sep	+4.7 Sep	+2.6	+4.0	6.5 Sep
Iceland	+5.0 Q2	+20.9	nil	+0.8	+0.4 2007	+15.9 Oct	+4.5	+12.0	1.9 Oct‡‡
Ireland	−0.8 Q2	−2.1	−0.5	−0.1	+4.0 Sep	+4.3 Sep	+4.6	+4.0	6.7 Oct
Latvia	−4.2 Q3	na	−0.4	−0.5	−5.4 Sep	+13.8 Oct	+13.2	+15.8	5.7 Jul
Lithuania	+3.1 Q3	+1.6	+5.1	+3.7	na	+10.5 Oct	+7.5	+10.8	4.7 Aug‡‡
Luxembourg	+2.8 Q2	+4.5	+2.8	+2.6	+11.9 Aug	+3.3 Oct	+2.9	+4.0	4.3 Sep‡‡
New Zealand	−0.3 Q2	−2.1	+0.4	+1.5	+2.4 Q2	+5.1 Q3	+1.8	+4.1	4.2 Q3
Peru	+8.9 Aug	na	+9.1	+6.5	+5.6 Aug	+6.5 Oct	+3.1	+5.7	7.7 Sep††
Philippines	+4.6 Q2	+8.4	+4.4	+2.3	+6.5 Aug	+11.2 Oct	+2.7	+9.6	7.4 Q3‡‡
Portugal	+0.7 Q2	+1.4	+0.4	−0.8	−4.3 Sep	+3.1 Sep	+2.1	+2.9	7.3 Q2‡‡
Slovakia	+7.6 Q2	na	+7.0	+5.2	+5.5 Sep	+5.1 Oct	+3.2	+4.4	7.5 Sep††
Slovenia	+5.5 Q2	na	+4.2	+2.8	+5.6 Sep	+4.9 Oct	+5.1	+6.0	6.4 Aug‡‡

*% change on previous quarter, annual rate. †*The Economist* poll or Economist Intelligence Unit estimate/forecast. ‡National definitions.- §RPI inflation rate 5.0% in Sept. ††Latest three months. ‡‡Not seasonally adjusted. ***Centred 3-month average

Sources: National statistics offices and central banks; Thomson Datastream; Reuters; Centre for Monitoring Indian Economy; OECD; ECB

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The Economist commodity-price index

Nov 13th 2008
From The Economist print edition

The Economist commodity-price index

2000=100

	Nov 4th	Nov 11th*	% change on one month	% change on one year
Dollar index				
All items	172.2	163.0	-11.8	-23.4
Food	185.3	178.1	-6.2	-8.1
Industrials				
All	155.2	143.6	-19.5	-39.5
Nfa†	136.3	128.9	-9.4	-26.6
Metals	165.5	151.6	-23.4	-44.1
Sterling index				
All items	162.4	160.3	+0.3	+3.0
Euro index				
All items	122.8	120.2	-4.2	-10.8
Gold				
$ per oz	761.00	729.50	-13.0	-8.8
West Texas Intermediate				
$ per barrel	70.08	59.33	-25.2	-35.1

*Provisional †Non-food agriculturals.

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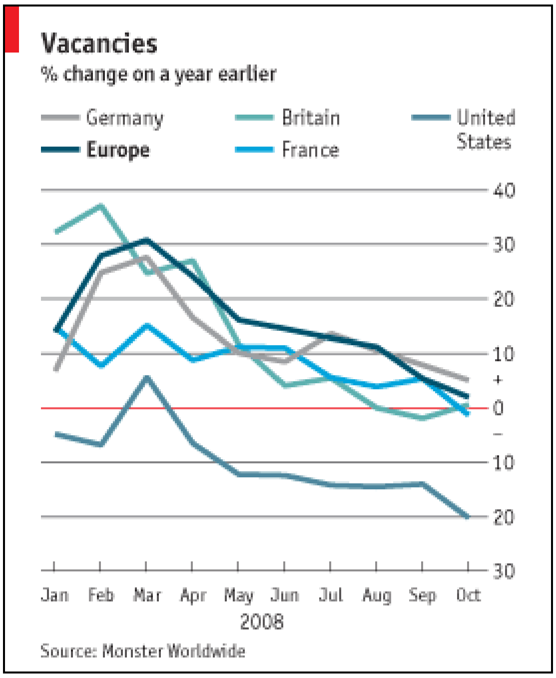
Vacancies

Nov 13th 2008
From The Economist print edition



Job recruitment in Western Europe and the United States continued to fall in October, according to the Monster Employment Index, which measures the strength of online hiring intentions. The European index declined for the third month in a row, but was nevertheless 2% higher than a year earlier. Within Europe, there were more vacancies in France and Britain than a month earlier. The index for America fell, following small increases in August and September, and was 20% lower than in October 2007. There were far fewer jobs available in real estate, retailing, and the leisure and hospitality industries in America. But in some sectors, such as public administration, mining and utilities, job offerings were more plentiful.

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Trade, exchange rates, budget balances and interest rates

Nov 13th 2008
From The Economist print edition

Trade, exchange rates, budget balances and interest rates

	Trade balance* latest 12 months, $bn	Current-account balance latest 12 months, $bn	Current-account balance % of GDP 2008†	Currency units, per $ Nov 12th	Currency units, per $ year ago	Budget balance % of GDP 2008†	Interest rates, % 3-month latest	Interest rates, % 10-year gov't bonds, latest
United States	−848.0 Aug	−699.0 Q2	−4.7	–	–	−3.2	1.40	3.66
Japan	+64.8 Sep	+185.9 Sep	+3.9	95.6	111	−3.0	0.69	1.50
China	+265.2 Oct	+371.8 2007	+8.5	6.83	7.43	0.4	3.87	3.07
Britain	−185.5 Sep	−82.9 Q2	−3.1	0.66	0.48	−3.8	4.15	4.11
Canada	+50.8 Aug	+13.6 Q2	+1.1	1.23	0.96	0.2	1.78	3.86
Euro area	−26.4 Aug	−36.2 Aug	−0.4	0.80	0.68	−0.9	4.29	3.62
Austria	−0.3 Aug	+14.5 Q2	+2.6	0.80	0.68	−1.0	4.29	4.23
Belgium	+3.3 Jul	−9.8 Jun	+1.6	0.80	0.68	−0.6	4.35	4.27
France	−80.7 Sep	−53.6 Sep	−1.8	0.80	0.68	−2.9	4.29	4.01
Germany	+288.4 Sep	+266.8 Sep	+6.5	0.80	0.68	0.9	4.29	3.62
Greece	−67.7 Sep	−50.8 Aug	−14.0	0.80	0.68	−3.3	4.29	5.08
Italy	−15.4 Aug	−71.1 Aug	−2.5	0.80	0.68	−2.6	4.29	4.66
Netherlands	+60.0 Sep	+62.5 Q2	+6.2	0.80	0.68	0.7	4.29	4.00
Spain	−154.9 Aug	−165.3 Aug	−9.8	0.80	0.68	−1.6	4.29	4.18
Czech Republic	+6.3 Sep	−4.3 Aug	−2.8	20.4	18.1	−1.9	4.22	4.33
Denmark	+6.5 Sep	+6.5 Sep	+1.3	5.95	5.07	3.8	7.30	4.03
Hungary	+0.4 Sep	−8.8 Q2	−5.5	216	173	−3.8	11.66	10.50
Norway	+83.2 Sep	+78.1 Q2	+17.3	7.06	5.39	17.7	5.85	4.34
Poland	−22.0 Sep	−27.3 Sep	−5.2	3.01	2.48	−1.8	6.79	6.46
Russia	+195.9 Sep	+116.5 Q3	+6.2	27.6	24.5	4.5	12.00	8.99
Sweden	+19.0 Sep	+38.6 Q2	+7.6	8.08	6.28	2.4	3.30	3.44
Switzerland	+17.3 Sep	+60.2 Q2	+13.0	1.18	1.12	0.9	2.18	2.61
Turkey	−75.6 Sep	−47.1 Sep	−6.4	1.65	1.17	−1.8	20.99	9.67‡
Australia	−14.0 Sep	−61.1 Q2	−5.1	1.55	1.11	0.3	4.84	5.08
Hong Kong	−27.2 Oct	+27.5 Q2	+10.8	7.75	7.79	0.7	2.04	1.90
India	−106.5 Sep	−21.9 Q2	−2.9	49.3	39.3	−4.3	7.42	8.20
Indonesia	+17.3 Sep	+6.3 Q2	+2.8	11,550	9,220	−2.0	12.26	12.30‡
Malaysia	+41.9 Sep	+35.3 Q2	+13.7	3.59	3.35	−4.8	3.64	5.55‡
Pakistan	−22.4 Oct	−14.0 Q2	−6.2	80.4	61.1	−6.7	15.44	23.91‡
Singapore	+22.9 Sep	+32.8 Q2	+18.6	1.51	1.45	1.0	0.78	2.38
South Korea	−12.2 Oct	−10.6 Sep	−3.3	1,360	914	1.1	5.63	5.58
Taiwan	+6.5 Oct	+32.6 Q2	+5.6	33.0	32.3	−1.8	2.45	1.86
Thailand	+3.7 Sep	+5.4 Sep	+1.1	35.0	33.9	−2.9	3.85	3.69
Argentina	+15.9 Sep	+6.0 Q2	+2.7	3.31	3.13	0.7	22.94	na
Brazil	+26.5 Oct	−25.2 Sep	−1.8	2.29	1.74	−1.6	13.64	6.16‡
Chile	+14.4 Oct	+1.0 Q2	−0.5	647	505	6.5	8.28	5.26‡
Colombia	+2.3 Aug	−4.9 Q2	−2.6	2,344	2,031	−1.0	10.16	8.63‡
Mexico	−11.3 Sep	−5.3 Q2	−0.8	13.1	10.9	nil	7.08	9.48
Venezuela	+41.9 Q2	+37.8 Q2	+14.8	5.00	6.20§	1.6	17.00	6.55‡
Egypt	−23.4 Q2	+0.9 Q2	+0.2	5.53	5.52	−7.1	12.76	6.87‡
Israel	−13.7 Sep	+3.5 Q2	+0.9	3.89	3.93	−0.8	3.51	5.11
Saudi Arabia	+150.8 2007	+95.0 2007	+31.7	3.75	3.74	13.3	4.08	na
South Africa	−10.6 Sep	−22.5 Q2	−7.7	10.5	6.62	0.2	12.40	8.83
MORE COUNTRIES Data for the countries below are not provided in printed editions of *The Economist*								
Estonia	−4.3 Aug	−3.3 Aug	−11.8	12.5	10.7	−0.5	7.77	na
Finland	+11.9 Aug	+10.6 Aug	+3.8	0.80	0.68	4.5	4.33	4.09
Iceland	−0.6 Oct	−4.5 Q2	−14.6	137	59.8	2.0	18.45	na
Ireland	+39.0 Aug	−15.8 Q2	−3.5	0.80	0.68	−3.9	4.29	4.49
Latvia	−6.4 Sep	−5.5 Aug	−15.0	0.57	0.48	−1.5	9.65	na
Lithuania	−7.9 Sep	−6.8 Aug	−14.0	2.76	2.35	−0.7	7.39	na
Luxembourg	−6.9 Aug	+5.1 Q2	na	0.80	0.68	0.5	4.29	na
New Zealand	−3.7 Sep	−11.4 Q2	−7.1	1.78	1.31	0.3	6.50	5.88
Peru	+5.5 Sep	−1.5 Q2	−1.6	3.10	3.00	2.7	6.50	na
Philippines	−8.5 Aug	+4.3 Jun	+1.7	49.0	42.9	−0.9	4.25	na
Portugal	−33.6 Aug	−27.9 Jul	−9.7	0.80	0.68	−2.4	4.29	4.40
Slovakia	−0.8 Sep	−6.1 Jul	−5.6	24.3	22.5	−2.1	0.97	4.32
Slovenia	−4.6 Sep	−3.5 Aug	−6.6	0.80	0.68	0.4	4.29	na

*Merchandise trade only. †*The Economist* poll or Economist Intelligence Unit forecast. ‡Dollar-denominated bonds. §Unofficial exchange rate.
Sources: National statistics offices and central banks; Thomson Datastream; Reuters; JPMorgan; Bank Leumi le-Israel; Centre for Monitoring Indian Economy; Danske Bank; Hong Kong Monetary Authority; Standard Bank Group; UBS; Westpac.

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MARKETS & DATA

WEEKLY INDICATORS

Markets

Nov 13th 2008
From The Economist print edition

Markets

	Index Nov 12th	% change on one week	% change on Dec 31st 2007 in local currency	% change on Dec 31st 2007 in $ terms
United States (DJIA)	8,282.7	-9.4	-37.6	-37.6
United States (S&P 500)	852.3	-10.5	-42.0	-42.0
United States (NAScomp)	1,499.2	-10.8	-43.5	-43.5
Japan (Nikkei 225)	8,695.5	-8.7	-43.2	-33.6
Japan (Topix)	875.2	-9.5	-40.7	-30.7
China (SSEA)	1,953.0	+5.6	-64.6	-62.2
China (SSEB, $ terms)	99.0	+7.1	-74.7	-73.0
Britain (FTSE 100)	4,182.0	-7.7	-35.2	-51.0
Canada (S&P TSX)	8,922.6	-9.8	-35.5	-48.2
Euro area (FTSE Euro 100)	733.3	-11.2	-46.7	-54.3
Euro area (DJ STOXX 50)	2,400.7	-11.4	-45.4	-53.3
Austria (ATX)	1,869.9	-10.8	-58.6	-64.5
Belgium (Bel 20)	2,057.5	-6.5	-50.2	-57.3
France (CAC 40)	3,234.0	-10.6	-42.4	-50.7
Germany (DAX)*	4,620.8	-10.6	-42.7	-50.9
Greece (Athex Comp)	2,010.5	-9.5	-61.2	-66.7
Italy (S&P/MIB)	20,227.0	-11.1	-47.5	-55.1
Netherlands (AEX)	249.3	-10.8	-51.7	-58.6
Spain (Madrid SE)	924.9	-11.4	-43.7	-51.8
Czech Republic (PX)	825.5	-8.7	-54.5	-59.4
Denmark (OMXCB)	248.8	-11.0	-44.6	-52.5
Hungary (BUX)	11,783.0	-18.2	-55.1	-64.1
Norway (OSEAX)	266.0	-18.2	-53.3	-64.1
Poland (WIG)	27,590.6	-5.1	-50.4	-59.5
Russia (RTS, $ terms)	634.9	-23.5	-68.9	-72.3
Sweden (Aff.Gen)	191.3	-10.2	-43.8	-55.0
Switzerland (SMI)	5,702.9	-7.7	-32.8	-35.5
Turkey (ISE)	25,342.5	-9.0	-54.4	-67.6
Australia (All Ord.)	3,883.6	-9.4	-39.5	-56.0
Hong Kong (Hang Seng)	13,939.1	-6.1	-49.9	-49.6
India (BSE)	9,536.3	-5.8	-53.0	-62.4
Indonesia (JSX)	1,326.6	-2.9	-51.7	-60.7
Malaysia (KLSE)	890.3	-2.7	-38.4	-43.3
Pakistan (KSE)	9,183.1	nil	-34.8	-50.0
Singapore (STI)	1,784.0	-4.5	-48.5	-50.9
South Korea (KOSPI)	1,123.9	-4.9	-40.8	-59.2
Taiwan (TWI)	4,615.6	-7.3	-45.7	-46.6
Thailand (SET)	435.7	-4.7	-49.2	-51.1
Argentina (MERV)	1,008.3	-11.2	-53.1	-55.4
Brazil (BVSP)	34,373.0	-9.0	-46.2	-58.2
Chile (IGPA)	11,790.7	-3.4	-16.3	-35.5
Colombia (IGBC)	6,998.3	-2.6	-34.6	-43.7
Mexico (IPC)	18,805.0	-8.0	-36.3	-47.1
Venezuela (IBC)	35,340.2	-0.2	-6.8	-60.0
Egypt (Case 30)	5,021.9	-6.2	-52.0	-52.2
Israel (TA-100)	630.5	-9.5	-45.4	-45.9
Saudi Arabia (Tadawul)	5,485.2	-9.8	-50.3	-50.3
South Africa (JSE AS)	19,670.5	-6.1	-32.1	-55.7
Europe (FTSEurofirst 300)	853.9	-10.4	-43.3	-51.5
World, dev'd (MSCI)	870.0	-11.5	-45.2	-45.2
Emerging markets (MSCI)	533.5	-11.1	-57.2	-57.2
World, all (MSCI)	215.2	-11.5	-46.6	-46.6
World bonds (Citigroup)	737.9	-0.3	+1.0	+1.0
EMBI+ (JPMorgan)	357.5	-2.6	-17.6	-17.6
Hedge funds (HFRX)	1,061.5	-0.8	-20.2	-20.2
Volatility, US (VIX)	66.5	54.6	22.5	(levels)
CDSs, Eur (iTRAXX)†	156.2	+18.5	+208.7	+164.4
CDSs, N Am (CDX)†	214.1	+9.6	+174.9	+174.9
Carbon trading (EU ETS) €	18.0	-3.3	-19.1	-30.7

*Total return index. †Credit-default swap spreads, basis points.
Sources: National statistics offices, central banks and stock exchanges; Thomson Datastream; Reuters; WM/Reuters; JPMorgan Chase; Bank Leumi le-Israel; CBOE; CMIE; Danske Bank; EEX; HKMA; Markit; Standard Bank Group; UBS; Westpac.

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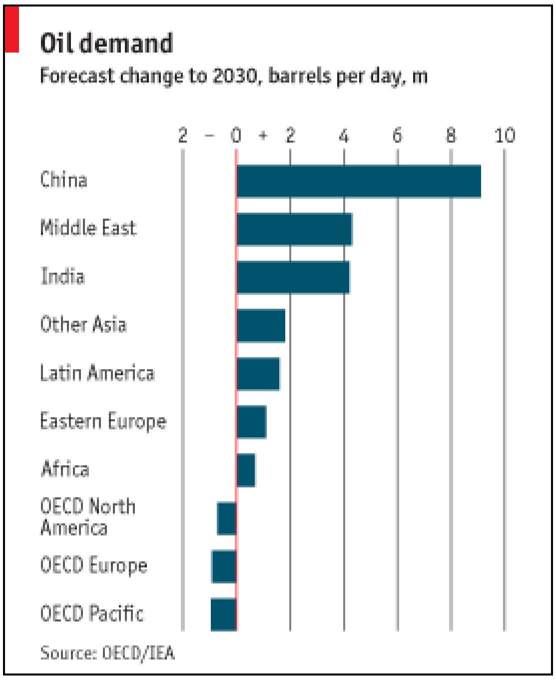
Economist.com MARKETS & DATA
WEEKLY INDICATORS

Oil demand

Nov 13th 2008
From The Economist print edition



The world's demand for primary energy will grow by 45% between 2006 and 2030, according to new forecasts from the International Energy Agency (IEA). The global demand for oil is expected to rise from 85m to 106m barrels a day. The thirst for oil among the mostly rich countries in the OECD is set to fall—so that all and more of the increase in oil demand will come from developing economies. The IEA reckons China will account for 43% of the rise in demand, with India and the Middle East contributing around 20% each. With oil consumption comes pollution. The IEA predicts that three-quarters of the increase in emissions between now and 2030 will come from China, India and the Middle East.

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